PREFATORY NOTE

These transcripts have been produced from the original raw transcripts in the FOMC Secretariat's files. The Secretariat has lightly edited the originals to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcripts were not fully edited for accuracy at the time they were produced because they were intended only as an aid to the Secretariat in preparing the records of the Committee's policy actions. The edited transcripts have not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Meeting of the Federal Open Market Committee

May 20, 1986

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, May 20, 1986, at 9:15 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Guffey
Mrs. Horn
Mr. Johnson
Mr. Melzer
Mr. Morris
Mr. Rice
Ms. Seger
Mr. Wallich

Messrs. Boehne, Boykin, Keehn, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Black, Forrestal, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco, respectively

Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Bradfield, 1/ General Counsel
Mr. Oltman, Deputy General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. J. Davis, T. Davis, Kohn, Lindsey, Prell, and Siegman, Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account
Mr. Cross, Manager for Foreign Operations, System Open Market Account

1/ Entered meeting after action to approve minutes for meeting of April 1, 1986.

Mr. Coyne, 1/ Assistant to the Board, Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International Finance, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Mr. Fousek, Executive Vice President, Federal Reserve Bank of New York

Messrs. Lang, Rolnick, Rosenblum, Scadding, Scheld, Thieke, and Ms. Tschinkel, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, Minneapolis, Dallas, San Francisco, Chicago, New York, and Atlanta, respectively

Messrs. Burger, Cook, and Fieleke, Vice Presidents, Federal Reserve Banks of St. Louis, Richmond, and Boston, respectively

1/ Entered meeting after action to approve minutes for meeting of April 1, 1986.

Transcript of Federal Open Market Committee Meeting of
May 20, 1986

CHAIRMAN VOLCKER. Is there a motion to approve the minutes?

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection. Mr. Cross.

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any questions or comments?

MR. WALLICH. Is there some presumption that this situation will go on and eventually--[not] immediately--that there will be continuing pressure?

CHAIRMAN VOLCKER. Excuse me, I was distracted.

MR. WALLICH. Sorry, I was trying to say that [the dollar] was being held up temporarily, but over time--half a year, a year--would this look toward continuing pressures on the dollar?

CHAIRMAN VOLCKER. Would what look toward continuing pressures?

MR. TRUMAN. I think the question, Mr. Chairman, is whether a resumption of downward pressure on the dollar is expected.

MR. CROSS. Well, that certainly is going to depend very much on how the economic data unfold. But one thing that has been an important factor in the dollar having stopped its decline has been, if not a change in the comments and rhetoric and the statements made by a number of officials in a lot of countries, certainly a view in the market that the attitudes of the officials in those countries--here and in Japan and in Germany--are such that there tends not to be concern about the level of the dollar now. Or, at least these countries are not pressing to see it go down further. And in the view of the Europeans and the Japanese, there is the beginning of an expression of some concern should the dollar go down further. So I think we've seen in the market during this period great attention paid to official attitudes; and there is a different perception in what those attitudes are. There is a view that at least for the time being there is not felt to be any need to try to guide the dollar down further.

CHAIRMAN VOLCKER. I don't think there's any safe bet as to what the market will do over the next 6 months to a year.

SPEAKER(?). Or two weeks.

MR. FORRESTAL. Sam, are the Japanese continuing to show an interest in the government securities market?

MR. CROSS. Peter can comment on that, but as far as we can tell they're showing a considerable interest in the government securities market. Apparently, they picked up quite substantial amounts of the latest issues. We did hear in the first part of April that the long-term capital outflows from Japan were declining, but the most recent information--and we talked to the Japanese a few days ago --was that the capital outflows from Japan through April and early May have continued to be very large. Now, that doesn't mean it's all coming to dollars because there are some attractions in Australian and other currencies. Also, it doesn't mean that they aren't covering some substantial parts possibly by hedging; we don't know. But certainly, from what we can tell they are continuing to buy very substantial amounts of U.S. government securities.

MR. STERNLIGHT. I could add to that. As Sam said, they are certainly [active]; in this last bond auction they took roughly of a $9 billion auction. The interest does tend to be a little sporadic and one gets the impression in talking to people in the market that sometimes it's waning or sometimes waxing stronger. We have talked to some of the Japanese firms about it and we get the impression that there is more time and effort put into diversifying out of government securities into other dollar securities and into investments in the securities of other countries, but with some interest continuing in the dollar and in U.S. government securities.

MR. PARRY. Sam, what has been the change in the yen relative to other countries that are competitive with Japan like Korea, Taiwan, and Hong Kong?

MR. CROSS. Those currencies have tended to move with the dollar, so the yen has changed against them in the same way that it has changed against the dollar. And that is a matter that is causing some concern for them because they see the diversion of what they've been selling to Korea, being sold by Korea, Taiwan, and elsewhere. And we're seeing moves by the Japanese to shift to those currencies and to increase their ownership in output [facilities] from there.

CHAIRMAN VOLCKER. I'll ask you an impossible question, Mr. Truman. What will be the GNP increases in Japan and Germany in the first quarter? What would be your best guess at the moment?

MR. TRUMAN. My best guess on Japan is something like 2 percent at an annual rate--very low, and maybe something about the same order of magnitude, say, 1 to 2 percent in Germany. In both countries there were declines in industrial production in the first quarter.

CHAIRMAN VOLCKER. You think they were both positive anyway?

MR. TRUMAN. On the assumption that the nontraded goods component of the GNP continued to expand.

MR. JOHNSON. Is that in keeping with what their estimate is?

MR. TRUMAN. I would think in both cases it is.

MR. JOHNSON. I thought Germany had a more optimistic outlook than that.

MR. TRUMAN. Well, it's short of what their expectations were; there's increasing evidence from--

CHAIRMAN VOLCKER. Well, they had a more optimistic outlook earlier; there's no doubt about that. Recently, I think they have been very concerned about how low [their GNP] may have been in the first quarter.

MR. STERN(?). Ted, if you ranked policies around the world--at least in the United States, Japan and Germany--would we still be the most expansionary?

MR. TRUMAN. Well, on the fiscal policy side, certainly, although it depends on what you crank in for Gramm-Rudman. But in both of those countries we're seeing a continuing move toward fiscal restraint, a continuation of a 4- or 5-year trend. On the monetary side, for Germany in any case, they are substantially above their monetary growth [objective]. They were aiming for 5-1/2 percent in April and it was a little above 8 percent. That's one of the things that Sam referred to that they are concerned about and one of the things conditioned to their position in the EMS, which is restraining them from providing more stimulus on the monetary side. It's a little hard to read the monetary part in the short run [in Japan]. The Japanese really have moved toward a more expansionary monetary posture over the course of the first five months of this year.

MR. CROSS. Every time they--

MR. TRUMAN. Their monetary growth dipped down in April, but they too have been a bit concerned about the excessive monetary growth.

MR. BLACK. But if you look back a little farther, Ted, you wouldn't say that they had been as stimulative as we have been, though, would you? This is just recently.

MR. TRUMAN. Well, for most of the period up until very recently they were following a very tight monetary policy largely directed at keeping the yen from depreciating too much; there was a lot of pressure on them not to ease monetary policy because that would cause the yen to depreciate.

MR. CROSS. But they have changed the discount rate; they have lowered it 3 times and each time the yen has risen.

MR. JOHNSON. How do you think Germany will respond to such low first-quarter estimates, given the fact that even they, as you said, already have made it clear that even if they wanted to do something they're sort of boxed in by the French franc in the EMS?

MR. TRUMAN. Well, there is some talk that if it comes in low and the government does poorly in the elections in the second week of June--the second Sunday in June, I guess--that there might be some easing on the fiscal side. I think that has a low probability, but it is a possibility, I think.

MR. JOHNSON. What do you mean by easing on the fiscal side?

MR. TRUMAN. Well, I've been told that there are some modest fiscal expansionary measures--public works projects and so forth and so on. They have a national election in January and the implications of this June election are that they have enough time to move--to ease a bit to stimulate the economy if they're concerned--which I think is a very big "if." One of the problems in interpreting those election results, as Sam mentioned, is that they are going to be contaminated by Chernobyl. So there would be less of a mandate than one might want in the circumstances.

VICE CHAIRMAN CORRIGAN. A slightly different form of fallout!

MR. MORRIS. We seem to have a worldwide phenomenon of rapid monetary growth associated with slow real growth; it's not purely American.

CHAIRMAN VOLCKER. This is true at the moment.

MR. JOHNSON. Worldwide velocity problems!

CHAIRMAN VOLCKER. In more extreme form here.

VICE CHAIRMAN CORRIGAN. Yes. These measures aren't worth much, but if you use any kind of conventional measure of real interest rates, the United States right now is probably very much on the low side of real interest rate countries around the world. If you use an ex-post measure of inflation, who knows what real interest rates are?

CHAIRMAN VOLCKER. Mr. Sternlight.

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any questions?

MS. SEGER. Peter, do you sense that commercial banks have cashed in a lot of their paper profits in their bond holdings? Or have they just been playing it by ear and taking their time?

MR. STERNLIGHT. I think there has been some move to capture profits on some longer-term investments and to move somewhat shorter in the yield curve. I think they're staying invested, though--

MS. SEGER. Oh, I didn't mean that they're weren't staying invested but--

MR. STERNLIGHT. --especially given fairly weak loan demand. And that also would be characteristic.

MS. SEGER. How about their trading accounts? How are they running?

MR. STERNLIGHT. Well, they have been taking their lumps recently as market prices have moved down. There are some loss situations around--nothing super heavy among the bank dealers that I'm familiar with, but there are some adverse experiences.

MS. SEGER. Thank you.

CHAIRMAN VOLCKER. Any other questions? We have to ratify the transactions.

VICE CHAIRMAN CORRIGAN. So moved.

MS. SEGER. Second.

CHAIRMAN VOLCKER. Without objection. Mr. Kichline.

MR. KICHLINE. [Statement--see Appendix.]

MR. PARRY. Did that revision in the first quarter make you somewhat more pessimistic about the second quarter in terms of inventories?

MR. KICHLINE. Not much. We had available all of the data except for retail trade inventories when we put the forecast together, and they came in significantly higher than we thought. The Commerce Department will release tomorrow the detail on how it fits together, so we have much of this. We really were [not] surprised, frankly. We thought, given the degrees of freedom that they have in that area, that they might not have taken all of the implied revision into account; but our reading of the inventory side was that inventories generally were lean, with the exception perhaps of some major retail trade [firms]. So, we would not want to change very much as a result of this.

MR. BLACK. Jim, do you have the numerical figure on final sales?

MR. KICHLINE. Final sales had been minus 0.4 percent. They are now minus 0.7 percent. But I should give you another number: final sales excluding CCC purchases, because they are the big mover. If you exclude the Commodity Credit Corporation operations they had been rising 2.6 percent and now they are indicated to have risen 2.2 percent. The changes in these final sales are really quite small. Personal consumption expenditures, net exports, and residential structures were revised down, each by a small amount.

CHAIRMAN VOLCKER. CCC is way down in the first quarter on these estimates, but is that still positive?

MR. KICHLINE. Yes, it's just much less positive than before. The offset shows up in federal purchases, of course, if the accounts are kept straight. Federal purchases were up 23 percent at an annual rate in the fourth quarter and are now indicated to have declined 30 percent in the first quarter.

MR. JOHNSON. Which side of the trade account was revised? Or was it both?

MR. KICHLINE. Imports were less negative and exports were revised down a bit. So the contribution of net exports is a little less than had been projected before.

MR. PARRY. Jim, with regard to the forecast, if one were to assume tax reform roughly similar to the Packwood proposal, given the difference in timing between the elimination of exemptions and the effectiveness of the lower tax rates, how would that affect your estimates of real growth in 1987?

MR. KICHLINE. I think we were asked that question yesterday [at the Board meeting] and I suggested after a long answer that I don't know. Do you want the short answer or the long answer?

MR. PARRY. A short one will do.

CHAIRMAN VOLCKER. Well, I guess we can take whatever comments people have on the business outlook generally. Mr. Parry.

MR. PARRY. My view about the outlook is very similar to that presented by Jim, both in terms of real growth and also inflation. I would also agree that the dichotomy between what appear to be very favorable fundamental factors and the current sluggish performance of the economy clearly persists. However, in one area--the dollar--it would appear as though the favorable fundamentals for growth have improved, as Sam indicated. The dollar is now 6 to 7 percent less than it was in early April when we last met. On the other hand, I feel as though the current greater likelihood of tax reform indicates that fiscal policy may move in the direction of somewhat greater restraint than we have in our forecast and perhaps in Jim's as well.

In the Twelfth District we feel as though there are convincing signs of improvement. Southern California appears to be in the midst of a broadly based expansion, with particular strength in residential construction. In the Pacific Northwest, the forest products industry is posting its best performance in several years, with prices of some products up 22 percent over year-ago levels. The semiconductor industry is improving somewhat and strengthening orders for commercial aircraft have benefited companies such as Boeing in Seattle as well as many subcontractors in California. Finally, lower gasoline prices and concerns about terrorism abroad are expected to boost tourism revenues very substantially, especially in the Northwest with the added draw of Canada's Expo. Just as an aside, we know from an Alaskan banker that there isn't a room available in Anchorage for the entire summer as a result of the pickup in tourism activity. So cancel that city from your list. Areas heavily dependent on agriculture and energy continue to suffer, however. In California, drilling and rig activity are down very sharply and Alaska has been particularly hard hit. Estimates are that each dollar decline in oil prices costs the state of Alaska about $150 million in revenue loss.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Conditions in our part of the Midwest also are very largely unchanged from the last meeting. There is that general expectation that the third and fourth quarters will be significantly improved, but I must say the current level of activity is considerably under those expectations. As always, the areas that have been strong continue to be strong. I note particularly the real estate side, which is growing very, very rapidly pretty much across the board. And that, of course, pervades all of the related activities such as materials manufacturers, suppliers, and the like. Office building in the suburban Chicago area is beginning to slow down, but in the downtown Chicago area the projects are being completed and new projects are under way; I am quite surprised by the continuation of the heavy building in the commercial office building area. On the residential side in our District--and I guess this is typical of many parts of the country--over the last three months new permits for housing starts are up by some 40 percent over a similar period last year. So housing starts are growing very, very rapidly.

Alternatively, on the weak side, there is no really significant improvement in heavy manufacturing. Almost surprisingly, the decline in the dollar has not yet worked its way through in terms of a substantial pickup in orders and production. The environment is better, I am told, but in terms of actually getting deals it has not been much of a help. An exception to this is the paper board/paper box industry which is growing very, very rapidly; their order books early this year--in February, really--on the export side began to take off. So, they are exporting very heavily and that has been helpful.

On the inflation side, I have two comments. First, on pricing: Everybody I have talked to says that the pricing in the marketplace pretty much across the board is very fierce. They are just unable to get price increases to stick in any significant way. The labor side is consistent with what Jim has suggested. Contracts are continuing to be negotiated on very favorable terms: three-year contracts, with good changes in the work rules and improvement on the benefits side, so that unit labor costs seem to be under pretty good control. So, in an inflation sense, the outlook looks pretty good. Net, our outlook is consistent with the staff forecast; but having said that we would be pleased to see the whites of the eyes of the third- and fourth-quarter numbers because they look a little remote right now.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. Like the previous three speakers and like the staff, our forecast is for a pickup in the economy in the second half. But in fact we find the present situation disquieting. There is, of course, no evidence today of this pickup and in fact it may be postponed. I still believe that the past favorable developments will show through in the economy, but sometimes I worry that maybe they have already shown through in part in the numbers we are seeing right now and that we will see less of a pickup than we all are forecasting. I certainly would feel better if we were seeing movement in something besides the housing numbers.

Like other parts of the country, we are seeing good housing numbers in our District. I remind myself that under normal conditions, if I saw these kinds of economic statistics after such a long economic expansion, I normally would not be hopeful about the future. But the incoming employment numbers keep me somewhat more hopeful, perhaps. If I have special concerns today, I think they center around the trade numbers and the inventory numbers. On the trade side we expect a turnaround, and I would say that the business community expects a turnaround. In the Fourth District the business community, in spite of flat performance, is quite optimistic on the trade turnaround side and on the overall economic outlook. I do find, however, that there is beginning to be a difference between the expectations of the business community and of some of the economists I talk to who are beginning to be discouraged, particularly on the trade number, and who are talking about the need for the foreign exchange rate to go down further. On the inventory side, of course, good inventory numbers depend very much on what business expectations are. And I am concerned that, if this positive business mood I see begins to slip, we may then be in for an inventory correction. While I think our patience will be tested over the next several months, I remain optimistic about the second half; but with each passing month I grow more uncertain about it.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, we all seem to be pretty much of like mind this morning. In view of what we know now, I guess that is not unpredictable. We wouldn't have any difference at all with the staff's forecast for the balance of this year. Our guess would be--and of course it's purely a guess--that if in fact we do achieve those figures, we might be moving a little more strongly as we go into next year than the staff has projected, but just a tad more than what they are saying. I am somewhat cheered by the feeling that inflation will be down over this period, but I do think that we might justifiably have some concern about the sharp rise in the price of nonfuel imports in the first quarter of 1986. That was not the first quarter in which that has taken place. It is pointed out in the Greenbook, page 21 in the second part, that this could be a first step in the inflationary feedback we might expect from the substantial depreciation in the dollar that we have had over the last year or so. That is something that I think bears watching.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, the situation in the Southeast is not very different from that expressed by other speakers. On average in most sectors of the [District] economy and in most geographical areas there has been increasing strength in the first quarter and presumably through the second quarter as well. The notable exception, of course, is Louisiana. Generally, residential construction is quite strong in the Southeast as a result of lower mortgage interest rates. Refinancing has gone on at a very, very rapid rate. Commercial construction--and I should say it's really industrial construction--also is moving ahead rather strongly. There has been a shift from commercial development to industrial park development because of the high vacancy rates in commercial developments. Tourism also has improved as you might expect; and the expectation is that that's going to continue with the canceling of trips to Europe. Parenthetically, Eastern Airlines had anticipated adding--or perhaps they already had--one flight from Miami to Madrid; but that has been cancelled completely because of the lack of bookings. Consumer spending increased in March. So, in general those sectors appear to be very good.

As I indicated, the big exception is Louisiana. It now has the highest unemployment rate in the United States at a little over 13 percent. The rig count is the lowest since 1975 and the situation there is really quite serious. One of our directors reported that the only happy person in the state of Louisiana is Governor Edwards after the trial. The situation with respect to oil and energy has spread into the Gulf Coast areas of Alabama and Mississippi, which are also involved in those [activities], so that's going to be a negative area as well. In agriculture there is not very much new. It's a difficult situation and that situation has been exacerbated by the very severe drought that we have experienced--the worst drought, apparently, in over a hundred years. I have already talked about commercial real estate.

On the inflation side, we still get sporadic reports about price increases due to the decline in the value of the dollar, mostly in terms of Japanese goods. But those reports are very sporadic and there really is not very much evidence that the decline in the exchange value has worked its way into higher prices at this point. Wage negotiations continue to be moderate, although inflation in a couple of our cities like Miami and Atlanta is a bit above the national average. In general, the feeling around the District seems to be one of optimism--again, with the exception of Louisiana. People are looking for a strong second half and they are looking for a good 1987.

More generally, we agree entirely with the staff forecast. While the evidence is not yet in the statistics, we think that all of the fundamentals are in the pipeline--lower interest rates and all of the other things that we have talked about--to give us the kind of growth that the staff is forecasting for the second half of the year. We have no quarrel with that and we also agree with the inflation number. So in general, with the few exceptions that I noted, the Southeast looks pretty good and we think that we are going to get the kind of growth that the staff is forecasting throughout the nation in the second half of the year.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, our picture is a little different in that it is not looking too good. Economic activity is declining. The data for the first quarter show that while the decline has been modest it certainly is widespread. We expect the deterioration to be more severe in this quarter and also in the third quarter. The energy sector has been referred to already; of course, it has been very hard hit. The rig count is the lowest since WWII. The employment in that area, though, has not come down quite as much as one would have anticipated; it was down about 7 percent in March so our view is that we still have a lot more of that coming as we go along. Oil prices have come back a little, but it doesn't seem that the increase, at least yet, is enough to give drillers much encouragement. We would anticipate that prices probably could turn back down as we get on past summer. Construction is continuing to subside, particularly on the nonresidential side. The value of contracts has been sliding for several months. Employment has remained pretty strong and in fact is about at historically high levels in nonresidential construction; so here again we expect to see a sizable reduction in the work force as the projects come off and there are no new ones that are going to be replacing them. Other sectors of our economy are stagnant or declining. Manufacturing is affected by the weakness of energy and construction, and agriculture continues to do poorly. The financial position of many of our farmers also has been weakened further by the decline in oil prices because they are not getting the royalty payments from the oil wells that they have on their farms. Residential construction has been holding up fairly well but we would be more comfortable, as far as our financial institutions are concerned, if multi-family construction would drop off a bit.

In sum, Mr. Chairman, we just are not really seeing very much on the positive side in the Eleventh District. We share part of Louisiana--the part that Mr. Forrestal doesn't have--and he reported how that state is doing. New Mexico we share with the Tenth District and that is not doing all that great either. So, we are a little negative.

CHAIRMAN VOLCKER. Mr. Melzer, you will improve the spirits.

MR. MELZER. That's right. I will have to try to offset this. As was reported last month--and this is somewhat dated, but right now what we have for the District are first-quarter data--there is really strength across the board in terms of employment, construction, and consumer spending. Our District has been growing at a rate considerably in excess of the rate nationally. We have had particular strength in non-ag employment, including manufacturing employment, and also in residential construction. Also, in general in our area I think the commercial overbuilding is occurring at a later date, so we would still anticipate strength in commercial construction through this year with perhaps some slowing next year.

Just talking to people in terms of what's happening on a more current basis, I sense that the tone is very good in terms of attitudes. One specific piece of anecdotal information: A retailer I talked to some weeks ago expressed some confusion as to why furniture and consumer durable sales weren't really following the strength we have seen in housing, which normally is expected. There is now some evidence in a couple of the major cities in the District that those areas are beginning to pick up.

In my mind, one of the most significant developments in this intermeeting period has been the shift in market psychology. I have just focused on the government bond market, and I think there probably is some good news and bad news in that. I guess the good news might be that market participants, broadly speaking, may be somewhat more confident in their outlook about this forthcoming strength in the economy. I would agree with what has been said about this dichotomy we have had in the current outlook and looking down the road for some strength. I think there is some evidence in the bond market, anyway; I guess it's expressed in the form of concern that perhaps that in fact is going to develop. The troublesome aspect of all of this is what it might imply in terms of inflationary expectations. I think it was noted in Peter's report and in Sam's, to some extent, that there could be a psychology emerging whereby the best is behind us in terms of oil price declines. We are beginning to feel the impact of the decline of the dollar on prices, and perhaps we'll be moving into a period of cyclical recovery and have price pressures arising out of that. In connection with that we have had a steepening of the yield curve between the front end and the long/intermediate end of roughly 25 to 50 basis points. There is always the possibility that this is just congestion or indigestion from a large supply of securities, although all through this period we haven't really seen any supply problem showing through. I think it's significant to note this shift.

There is one other point related to the market: I attended the meeting of the Committee on Investment Performance about a week ago and it was interesting how many investment advisers--I would say at least three, maybe four, and these tended to be more stock-oriented people--cited one of the very positive factors in their minds in terms of the outlook for the markets in general was the liquidity that was in the economy. I think they were referring very specifically in that context to what they perceived to be a generally accommodative monetary policy. The question that raises in my mind is: If the feeling develops that maybe the major move is behind us and the financial markets people start to shift some of that liquidity into spendable balances--and in fact start to spend it against a backdrop of maybe some expectation of increasing prices--we could possibly be at a point where some of that liquidity that has been going into the economy gets pulled out for spending. That's just a question at this point, though.

CHAIRMAN VOLCKER. Let me just inject a question here. There have been a number of references to what favorable wage performances are signaling, which I certainly think has been true in the manufacturing or goods-producing side of the economy. However, that's a minority of the economy these days. What do you see going on in the service side where wages and salaries have been relatively high? Is there any improvement there?

MR. MELZER. I might comment on that. I think there is an expectation that the rates of increase will be lower this year than we experienced last year but still will be on the order of maybe 5 percent, down from 6 percent or something like that.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. On the national level, I think the issue has been stated as the dichotomy between the strength of the fundamentals and what that says about the outlook versus the sluggishness currently. The issue is how patient we will be to wait for those fundamentals [to show through]. As I look down the list of monthly indicators, while there is no strong evidence, I see a few straws in the wind. For example: the retail sales figure in April showed an increase that was the best since December; the housing start increase was the best since January; the industrial production increase was the best since January; the nonfarm payroll employment increase was the best since January; the [unintelligible] increase was the best since December. Now, that does not make a trend but I think there is a message there that maybe at the fringes we're beginning to see some evidence that [the expansion] might be picking up and that the lull in February and March may be behind us.

As far as my own District goes, we are better off than the nation. Philadelphia has an unemployment rate of 5-1/2 percent; it is lower in New Jersey and lower than that in Delaware. I was struck last weekend, as I was driving around running some errands, by the number of help wanted signs in the various store windows. So, I think the area is doing well. The attitude among business people is that they feel this lull but that the situation is really pretty good in the lull. Their attitude is positive; I wouldn't say it's robust. We feel the same boom in tourism: the Jersey shore, the Delaware shore, and the Poconos Resort areas are overbooked, if anything.

As to the question about wages in the services sector, last year I think the increases were running around 5-3/4 to 6 percent generally and in the financial area they were probably 6 to 6-1/2 percent. I would think it would be a touch lower, maybe broadly in the 5-1/2 to 6 percent area or perhaps a bit lower; but those markets are still fairly strong.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. Well, in the way of a description, I would start off by saying that the two-tiered economy or whatever term you want to use that has characterized our District for a long time continues to do so. Agriculture and the small part of the energy sector that we have continue to be under some significant pressures, and certainly that has spilled over into small-town retail trade and real estate, and so forth. Most of the rest of the District, though, continues to do well--unspectacular, but reasonably well. Expansion is fairly generalized in the rest of the sectors. What struck me between this meeting and the last one is that attitudes really seem quite good; they are distinctly on the positive side. I know many of you like to keep in touch with some of the more obscure parts of your Districts and we have obscure parts. One indication of the positive attitudes is that second home sales in northern Minnesota--in the Minnesota Lakes areas--have really picked up in the last few months. That business is just doing very, very well in places like Brainerd and Pequot Lakes, some of those kinds of locations.

VICE CHAIRMAN CORRIGAN. There are too many people going into these areas of Alaska and northern Minnesota now. They're going to take all the fish out of there!

MR. STERN. The second homes sales report was really quite striking to me, because I think it is indicative of some of the activity and the attitudes that exist in some of the more remote parts of the District now, actually northeastern Minnesota. Despite the problems, the Iron Range is undergoing something of a renaissance at the moment.

CHAIRMAN VOLCKER. We're not very good at manufacturing but we are really good at second homes!

MR. STERN. Apparently, yes. More fundamentally, I think the economy is likely to perform largely along the lines of the Greenbook forecast, although my own hunch is that we will probably get somewhat more growth, in real terms, in the second half of this year and early next year. But as time goes on, there is at least the risk--and I have some concern about it--that the mix will shift and will deteriorate in favor of more rapid price increases and less real growth. I must say that the tax reform proposal does strike me as something of a wild card, although presumably that front-loading issue--thinking about it in some form of permanent income context--ought not to be a big factor. At least that's where I come out. I do worry that as the expansion goes on--if we get the kind of acceleration in real growth that I think we will--that will in some sense start to sow the seeds, or at least raise the risks, of a pronounced deterioration in price performance over time. What is happening on the import price side right now and the state of liquidity in the economy are probably some of the straws already in the wind.

As far as your question about service sector wages, I don't have any first-hand information on that. But I will say that, at least in the Twin Cities, the help wanted signs in those kinds of establishments are very prominent and have been for quite some time. I would infer from that, at least, that there will be some continued upward pressure on wages as a consequence.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. I just want to make two brief [observations]. I generally agree with what has been said so far on the staff's forecast, although there are a couple of areas on which I differ a little. I am generally optimistic; I do see things picking up in the second half of the year. But I think we are going to be disappointed on the trade side. What I keep seeing in Europe and Japan indicates to me that we are going to get less growth out of the rest of the industrial world than we had been expecting and, therefore, our export markets are just not going to be there as strongly as we had anticipated. So, to the extent that we built that into our GNP estimates, I think it is not going to materialize as strongly as we might have thought. I do think things are going to look better domestically, although not as strong on our export side as we might have hoped.

My other concern is that velocity, or the demand for money, still seems to be a major factor. I think a lot of this is a carryover from the sharp decline in interest rates we have had and from the oil price situation, which has broken inflationary expectations another small notch. So we're having an increase in demand for other checkable deposits as a result. Just yesterday the staff was indicating that velocity growth has been around minus 9 percent for the second quarter. That is really a hefty decline, so we're on a similar--if not even sharper--trend than last year. I expect that to turn around a good bit in the second half of the year, but it has a lot of turning around to do. My expectation would be that this velocity weakness will probably squeeze nominal GNP a little further, so I am relatively optimistic about it. I hope that comes more out of the inflation side than the real GNP side; but given what is going on and my expectation on the trade side, I think that we probably will see a lower nominal GNP performance and maybe some sort of balanced squeezing between inflation and real GNP in the second half.

But once again, I think there is reason to be encouraged. I just think we are going to be disappointed on the trade side because Japan and Germany don't seem to be willing to pursue the kind of stimulative policies that we might like. I am talking about the fact that they have slack and potential from the oil price declines because they are major importers; I am not talking about demand driven type policies. They have a lot of potential and a lot of slack. Even if they are willing, they have some problems--institutional problems that [make them] resist being more stimulative. Germany, as I said, is boxed in by the EMS; they are at the bottom on the currency [arrangement] so they are in danger of falling outside their range if they try to get rates lower unless France goes along. Japan seems to be resisting lower interest rates through their postal saving system and there are a lot of other institutional areas of resistance. I think they are eventually going to adjust; they are just going to be slow to adjust. I think political pressures will be brought to bear after the elections in Germany, but hopefully it won't be the wrong kind of expansion. I am a little troubled by the idea of a public works project as a fiscal stimulus--being the source of expansion. I think they will be slow to adjust. I think our trade sectors are going to come around slowly.

CHAIRMAN VOLCKER. You talked about the trade sector. Just looking at these figures, the staff has a pretty healthy decline in the trade balance over the next 18 months. Would you explain that, Mr. Truman?

MR. JOHNSON. That's what I was getting at.

MR. TRUMAN. We are expecting, with the help of some growth abroad and the lagged effects of exchange rate change, to see a rather pronounced impact in terms of slowing of imports. Imports will continue to rise in nominal terms and we expect a rise in exports, so I think as far as the--

CHAIRMAN VOLCKER. What kind of rise in exports do you have?

MR. TRUMAN. Just in terms of the trade balance itself, we have nominal imports rising at a 12-1/2 percent annual rate over the four quarters of 1986 and nonagricultural exports rising at a 12-1/2 percent annual rate over the four quarters of this year. We had a 16 percent annual rate, we think, in the first quarter. So the balance is somewhat lower, 3 percent a quarter. For non-petroleum imports, we are looking for small declines--maybe in the 2 to 4 percent annual rate range for the balance of the year.

CHAIRMAN VOLCKER. You actually have declines in the rates?

MR. TRUMAN. In nonagricultural, non-oil, imports. On the oil side, we had a big drop in the first quarter and we will get quite a big snapback for three reasons: one, just the variability of the numbers and the big drop in the first quarter when they were rebuilding; second, gasoline and energy consumption are going up; and third, domestic production is going down. So there is quite a push on the quantity side of the import side in the short run--less in the way of a nominal trade balance than we would have--

CHAIRMAN VOLCKER. How do you measure a decline in domestic production?

MR. TRUMAN. It is very hard to estimate these things. I'll look it up and will give you at least an accurate estimate. We have something on the order of several hundred--I am not sure whether it is [unintelligible]--

MR. ANGELL. Are these data coming in or are they a forecast?

MR. TRUMAN. It's a forecast. We have domestic production going down by 300,000 barrels a day over the four quarters of 1986.

MR. ANGELL. Do you have any hard data?

MR. TRUMAN. Well, there are quite a lot. The production data lag, but there is a large amount of anecdotal information about the shutting of stripper wells, which account for some 80,000 barrels a day of total production in the United States.

MR. ANGELL. Well, it is true that in Kansas they are shutting wells that are coming in under a half a barrel a day. But I find that--

MR. TRUMAN. The estimates range from [unintelligible]. When you say something like 50 barrels a day at $15 a barrel--

MR. PARRY. On the point that you made, Mr. Chairman, about the reduced growth among our trading partners: Related to that is the fact that their currencies have appreciated even more, so that in itself is a factor that may be an offset.

MR. JOHNSON. I agree that that is something of a favorable offset. It is just that the discussion we have had here and everything I've ever read suggest that the income effect is really much stronger up front than those exchange rate effects; and the lags are long on those exchange rate shifts. It would be some time before we got an offset from that, if the demands were to fall seriously behind in Europe and in Japan.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. Well, I won't repeat the comments I have heard about the unevenness, the 2-tiered or 3-tiered [economy] or whatever it is, and the lots of tears in Dallas. I agree with the staff forecast of a pickup in growth in the second half of the year. What I would like to concentrate on are some question marks that I see--things that may prevent that pickup from happening, even though I would like to see it happen and I don't know that it won't. One thing is this whole issue of tax reform. Practically every business person that I have talked with seems to be discussing that. Last week I chatted with a homebuilders group. They had done a survey and it may be interesting to hear what they concluded--this was based on the Senate Finance bill--about the impact on the overall economy. The impact on single-family housing would be positive, but they thought that the impact on multifamily housing for sale and on rental office building and commercial and industrial construction would be negative. And a substantial group thought it would be very negative. Anyhow, it is impacting on a lot of decision-making and is causing many decisions to be postponed. I don't know how that will work out for the rest of this year--whether in fact it will bring about some extra activity late in the year. If we know, for example, that certain changes will take effect on January 1, maybe we could get a blip late this year followed by a little hole the beginning of next year. I just think it is something to look at. As Jim said, our econometric models don't give us good answers as to what this will do, but I think it is worth considering.

In the auto sector, I believe Jim mentioned that the auto [production] cutbacks had cost us about 1-1/4 percentage points in this quarter. I wonder, given the size of the inventories as of May

1, if maybe we won't have to see some more paring back in the third quarter because they are at close to 2 million units and that is probably 400,000 to 500,000 units above where they would like to have them. Have they taken enough out of production schedules to achieve that, given the current sales pace? Again, I don't know the answers; these are just questions.

MR. KICHLINE. It depends, obviously, on what they do with their incentives and whether they are going to gin up some more sales by doing something on the price side. In the GNP sense, in billions of dollars, the second-quarter change in the automobile sector is worth about $15 billion in real terms. We have [projected] another $3 or $4 billion in the third quarter which indicates that, yes, they are going to have to take more out. Now, that assumes that they have already [unintelligible] the working off of current-quarter production schedules; we think that they will have to do more. One of the difficulties that I might note here is that the Commerce Department uses seasonal factors that some might doubt. But using our information, they have their seasonal auto production going from 9 million units in the first quarter to 7.3 million in the second quarter. So it's a big dip. And we assume that a small further cut will occur in the third quarter.

MS. SEGER. Okay. Another thing that has suddenly started to bug me is the feedback of these weak sectors on the Treasuries of various states and what that may do to their urge to spend. I understand that several states already are noticing the problems with tax collections. Is this not something else that could change and contribute to some sort of drag on the economy? Also, the revenue sharing, I believe, is continuing to be attacked here in Washington. For many states--at least the one I am from--the revenue sharing has funded many, many different activities. My final question involves what Manley was mentioning about trade and how quickly the improvement will actually show up in the data. My gut reaction is that the lags may be longer than any of us would like to see. I am not disputing your forecast at all; I am just suggesting that maybe these are some of the matters that could in fact [unintelligible] on it. Thank you.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, New England remains a fully employed economy. Our regional unemployment rate is under 4 percent, despite the sizable decline in employment in the computer industry. The decline in employment in that industry was more than offset by the rise in employment in construction and financial services. As a consequence of a fully employed state, we find that wages are rising more rapidly, as you might expect, in New England than in any other part of the country. In the financial sector, wages are rising more than are wages in general; in that sector the average wage increase this year is probably around 6-1/2 percent. Within the financial sector, the mutual fund industry is in a boom condition and much of that is centered in the Boston area. One other fallout of the fully employed state has been an explosion in housing prices. Boston real estate on average is up by 75 percent in the past two years. And companies are finding it difficult for the first time to transfer people into Boston from other parts of the country because of the cost of housing. We are now at or slightly above the San Francisco housing market. The prospects for New England in the year ahead could well be a severe labor shortage situation because we have a number of new plants under construction, mostly in the defense/electronics area, that will have to be manned. If capital spending rises or the computer industry bounces back and if our exports in this country rise, we would gain strength from that as well because we export more of our manufactured products than any other part of the country. So, as I see the New England situation, we are heading toward a hyper fully employed situation. There is a lot of diversity in this country at the moment, particularly between Mr. Boykin's District and mine.

MR. BLACK. Do you think it would help to relieve the situation if you took a bunch of Texans up there?

MR. MORRIS. I think we could import Texans if they can find a place to live.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Strangely enough, in far north Dallas I was out on the weekend and went into 14 houses, brand new, that are on the market for sale at prices ranging from $475,000 to $800,000. And they think they are going to sell them!

MR. BLACK. Did you settle on yours?

MR. BOYKIN. Oh no, I just like to see what they are doing. That is way out in the country.

CHAIRMAN VOLCKER. How are land prices doing, Mr. Guffey?

MR. GUFFEY. They are continuing to fall, Mr. Chairman. As far as agricultural land values, from the survey that we take at the end of every quarter, they are down another 5 to 6 percent across the District; that would be roughly 50 percent of their highs in 1981. With respect to the agricultural sector, the winter wheat crop is in good shape; it's perhaps a very good crop. The other plantings that would take place in the spring are going forward well ahead of the usual schedule. There are about 5 to 7 percent of agricultural borrowers that will not get credit this spring and, as a result, something will have to be done with respect to foreclosure. They will not be able to put in a crop. So, there is some good and bad in the sense that the crop is good and commodity prices are up marginally, largely because of the Russian disaster. On the other side of the coin, red meat prices are down largely because of governmental programs with respect to the dairy herd buyout which depressed red meat prices very substantially.

In the energy sector, the story has already been told. What has happened to Bob Boykin's District has happened to the Tenth District in spades. For example, the rig count as of January 1 in the Tenth District was at 550; in May it was 236. And that [compares with] a number of about 1700 working rigs in the District at the height of the oil boom. As far as manufacturing is concerned, again, it's a mixed picture. Missouri, as I think you know, is second only to Michigan in auto assemblies. Those plants are going full out so that in the urban areas, particularly Kansas City, things are looking very good and unemployment is lower than the national average. On the other hand, general [unintelligible] aviation aircraft, farm machinery, and oil fuel equipment are all depressed sectors. Again, it's a mixed bag. Commercial construction in Kansas City and Omaha looks very good and suburban Denver is still going pretty strong. Downtown Denver, Oklahoma City, and Tulsa aren't [unintelligible] like Houston and perhaps Dallas will be someday. Residential construction is following that trend; that is to say, in the urban areas in which there has been low unemployment and good activity--for example, Kansas City and Denver--residential construction is very, very strong. But it is severely depressed in Oklahoma, whether it be Tulsa or Oklahoma City.

One of the things I would like to call attention to, and Martha has already referred to it, is the revenue shortfalls that are coming out of this depressed agriculture/energy economy. Oklahoma, Kansas, Wyoming, and Nebraska all are experiencing shortfalls in revenues. And this is sort of a double-barreled effect in the sense that the revenues are not coming in and the states and other municipalities are looking for revenues and are increasing taxes, whether sales taxes or otherwise. It is impacting those states and will keep them largely depressed--unless some other good events such as Chernobyl happen, I guess!

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. Just a couple of brief comments: On the general outlook, I find myself in the same ballpark as the staff forecast. I look at the situation right now using that forecast as a benchmark and I guess it's one in which I see some downside risks and some upside risks; I think they are fairly well balanced. The big downside risk is the one that Governor Johnson pointed to: the trade side. I've looked at those forecasts for the trade accounts by product, by country, and any other way I can look at them, and I am a little skeptical that we can see the kind of improvement that I think is built into most forecasts. The other side of the coin is that if indeed we begin to see the kind of recovery take hold that is built into most forecasts--not just Jim's--I think we've got to keep in mind that it's a forecast in which on balance the growth in consumer spending is modest in real terms, business fixed investment is sluggish in real terms, and inventories generally are rather modest. And the question, of course, is if things start to roll will those rather modest increases in consumer spending, fixed investment and inventories all begin to gain their own momentum? So, there are risks on both sides and I wouldn't want to try to choose which are the greater risks.

As a matter of perspective, we either just passed or are about to pass the 3-1/2-year mark in this expansion. Over the past year I think we've been a little lucky, in a somewhat curious way, in that different sectors of the economy have carried the load at various points and for various periods of time. Right now there's no question that housing is carrying the load. I think we've been lucky in some sense in the way that things have phased in and out and kept the overall momentum distinctly on the plus side, though not as robust as perhaps some would wish.

Looking at the situation more from a Second District perspective, I think a couple of things stand out. Outside of New York City itself we really do get the sense that the medium-size firms, even in manufacturing, are doing reasonably well to quite well. But the very, very large firms--mostly ones headquartered in New York with operations all over the country and the world--still are stumbling, with one prominent exception and that bears on the point somebody else made earlier. We do get reports from that their consumer-related appliances--refrigerators and that kind of thing--are now really very strong. "Full-out" is the way it's being described to me. So that bears on this feedthrough effect from the housing side. In New York City itself, office buildings are very strong. In the suburban New York areas, I think we have precisely the same situation that Frank mentioned in Boston in that there is something close to an outright boom going on in terms of the housing market and housing prices particularly. Some of that unquestionably is a reflection of the fact that for better or worse, and I guess it's for better, the financial side of the economy in New York City itself--not just banking, but the whole ball of wax--is throwing off just a tremendous amount of income. Wages and salaries in that area are growing very rapidly, but the standard wage bill doesn't begin to capture it. People will tell you about salary increases of 6 to 7 percent, but what has happened is that various forms of incentive compensation and bonus compensation are now widespread. They were once largely the domain of the investment banks but now they are everywhere. And the payouts under these various plans are truly enormous. And as I said, there's no question that in a major way that is feeding the frenzy that we see in the housing market in particular.

In terms of a longer-term outlook, there are a couple of concerns that one hears about. One is the one that I think Gary Stern and Tom Melzer mentioned: that while the inflation outlook right now and for the foreseeable future is terrific, what might it be out somewhere in 1987 in a context in which the economy is very strong, import prices are feeding through, and the beneficial effects on prices of the oil situation are largely behind us? The other concern that one hears more and more about--and I guess this is a bit of a problem coming out of the closet--is a concern that basically says that maybe these go-go financial markets have gotten a little too much go-go in them. The concern is not just in terms of prices but in terms of all the exotic activities and the implied uncertainties and risks associated with these various patterns of behavior; it's a kind of nagging feeling that there are vulnerabilities there that perhaps are not fully understood. And that uncertainty, as it can bear on this financial marketplace broadly defined, I think is getting a great deal more attention.

In closing, one anecdotal comment: I was poaching in Mr. Parry's territory Saturday at the [unintelligible] meeting and two things surprised me. One was that there was an article on the front page of the Phoenix paper that said that four of the highest paid executives in Phoenix were bankers and that two of them were making over $1 million a year. I then had occasion to visit one of the new communities developing way up north of Phoenix. And there around a golf course, Desert Highlands, were 70--seventy!--houses under construction. And they start at $1 million.

MS. SEGER. Yes, but they attract a lot of retired executives.

CHAIRMAN VOLCKER. I don't know what business or who they are attracting! Governor Angell.

MR. ANGELL. The world economy still seems to have a fairly high saving rate. I keep thinking about the fact that the economies with the higher saving rates over the last 4 or 5 years have also been growing the fastest; they have gotten larger. In addition to that, if you take the exchange rate move in dollar terms, the Japanese saving rate gets to be a lot larger than it was when you translate it in yen terms. And then when you add the oil recycling and redistribution, that seems to redistribute income to areas where the saving rates remain high. At the same time, I keep thinking about all the investment spending that was spurred in the 1970s when oil prices were rising. Everyone was building tankers and pipelines and nuclear plants and hydro-electric facilities, and these are all long-term kinds of investment demand. It was not just one country; it was a world-wide phenomenon. But we don't have that left anymore; all we have left to do is build buildings and aircraft. So it doesn't seem to me that there's much to indicate that the world economy is going to be moving forward with all that much vigor. World prices seem to be dominated by the fact that there are people out there, particularly in the Third World, who are trying to get hold of dollars and want those dollars. I think the world may see enough supplies in agricultural commodities that I don't see much of a bright outlook in regard to the U.S. share of the agricultural world in time to do much help in this decade. So it seems to me that what Jerry Corrigan and Manley Johnson talked about in regard to the exports is rather doubtful. The United States is still the largest exporter in the world. And I think it's going to be a very difficult market to compete in. The people that had those trade surpluses aren't going to give them up very easily because they don't want to take the employment drops that would occur if they gave up their balance of trade surplus positions. So, I think there's going to be a very significantly competitive market. Maybe we will make some gains in regard to reducing our imports, but not everybody can do that and a lot of countries are trying. So, [the foreign sector] seems to be a drag as far as I can see.

Corporate profits released this morning seem somewhat disappointing again. That indicates that the stock market may be more interest rate driven rather than anything else. I don't know what that has to show. I would note, when you look at housing prices in Boston and Tokyo, that it really is rather difficult in a mobile world for housing prices to get too high in one area compared to another because it does translate, eventually I presume, into higher wage rates. We hope you'll pay higher rates in Boston and drive those firms out of that area and into other parts of the United States; it would be really welcomed. I don't know that we necessarily have to move Texas to Boston, but it's really difficult to go a long time with one area of the country having a rather significant revival and other areas of the country having very bad [times]. If market forces work, we can expect land prices to adjust and housing prices to adjust and wage rates to be more attractive somewhere else. So I'm really pleased to see that.

My real difficulty at this moment is that the staff forecast for the 1987 inflation rate just scares me to death. Maybe it's wishful thinking that it's not going to be there. But if it is, it's way too high. If we're going to do anything about it, we ought to do something about it now. And I don't know if I have the courage to go, in terms of tightening monetary policy, to where it ought to be tightened if that staff forecast is correct. So, I'm in a real dilemma. I just can't feel any satisfaction in being a participant in a monetary policy that might lead to those kinds of results. But I guess I want to see the whites of the eyes of this third-quarter recovery; and if it's there, then I think we might have to take some action. I'm somewhat more optimistic on prices, but I don't trust myself against the rest of you.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, I'd just like to join the general agreement that has been expressed around the table that the staff forecast is right--that the current economic indicators are mixed and that the current sluggishness that we seem to be seeing will give way to acceleration in the second half. But I suppose the main question is: What would be the timing of the acceleration and the size of it? I myself would expect that we will see this acceleration sooner rather than later--that is to say, that we'll certainly see some strong evidence of it in the third quarter rather than the fourth quarter. And I would expect the acceleration to be strong rather than moderate. I also share some of the concerns expressed around the table that, with the likely increase in import prices and the acceleration that I anticipate, we may begin to see some inflationary pressures emerging but not in the near term. I would be concerned about the possibility of inflation much farther out into the second half of 1987. But my concerns would be there and I think that's a factor we should not lose sight of. On that I would see the risks pretty predominantly on the up side.

CHAIRMAN VOLCKER. If nobody else has any comments--

MR. FORRESTAL. I might just go back, Mr. Chairman, to your question about wages. When I mentioned wages and prices in the Southeast I had in mind manufacturing; in the services sector we're looking at 5-1/2 to 6 percent increases, but substantially higher in the financial services area.

CHAIRMAN VOLCKER. I haven't heard a lot of concern expressed--although there has been some--about the impact of this tax bill on commercial construction, which is in a vulnerable position anyway we keep saying. A couple of people have mentioned it but they didn't put enormous emphasis on it. I don't know.

MR. PARRY. It should be substantial in terms of changes in depreciation regulations. Also, for rentals I think the maximum loss one can write off is $25,000, which is not very large.

CHAIRMAN VOLCKER. There is certainly a change in the tax incentives for all these partnerships and so forth. I don't understand it all, but it's a big change.

MR. WALLICH. May I say a word? The [forecast for] the United States seems entirely plausible but it might be quite different from what many objective viewers think, and I think we have to take more account of [unintelligible]. If we don't, we're going to get an increase in the negative trade [unintelligible]. We're seeing it now already in the notion of what these countries are able to do. And I think we have to begin to look more at this impact [unintelligible]. But the possible pressures that may occur in some countries, including the [major] ones--not from one year to the next but over several years--could begin to [present a different] and more difficult picture of these outcomes.

CHAIRMAN VOLCKER. Let's turn to Mr. Kohn and get the monetary side of the equation, and then have a doughnut.

MR. KOHN. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Let me just raise one question that I raised yesterday, which you probably don't have any answer for at this point. You mentioned the great liquidity in the economy; some other people have mentioned that. Yet, if you look at our liquid assets series, it hasn't been doing much. Can you explain that dichotomy?

MR. KOHN. I think there are two things that explain it. If you look at the components, you can see that this must be a seasonal adjustment problem more than anything else. Short-term Treasury securities, which were very strong in November and December, have been running off on balance in this seasonally adjusted series in 1986. Now, the Treasury clearly has continued to rely on coupons for most of its financing but I don't believe there has been a change in its basic financing pattern here. So, L was stronger in the fourth quarter of last year than it is now, and it's partly I think--

CHAIRMAN VOLCKER. Basically a phenomenon of how many bills the Treasury is issuing.

MR. KOHN. Well, the Treasury has been paying bills down a bit, about $400 [million] an auction over the last couple of auctions.

MR. ANGELL. Is it the number? He should have the number on the U.S. residents--

MR. KOHN. Well, this would be the number of short-term Treasury securities owned by [unintelligible].

MR. ANGELL. Consequently, if you had an increase in foreign holdings, that would result in a reduction.

CHAIRMAN VOLCKER. If there was a big change, yes.

MR. MORRIS. But I think if you look at the trend in total liquid assets in the last two years, the trend is down.

CHAIRMAN VOLCKER. Yes, I know.

MR. MORRIS. So, I don't think you can explain those two years--

MR. KOHN. No, the other phenomenon that I was going to note is the runoff in commercial paper this year. Partly we're seeing that bankers' acceptances were weak in March and partly we're seeing the shift to longer-term financing by businesses. They are issuing more bonds and issuing less short-term paper. And the public is shifting its asset holdings from short-term paper into bonds. We see this in M2 also. M2 has been depressed in part because the public has shifted into these mutual funds that President Morris has commented on.

CHAIRMAN VOLCKER. Would you conclude that it had any policy implications or not?

MR. KOHN. I don't think it has particular policy implications beyond what you might garner from the fact that M2 is also running weak in the range--that is, that the buildup in liquidity broadly measured isn't that large. But it's very, very concentrated at the very liquid end of the spectrum: in M1 deposits, saving deposits, MMDAs, and such.

MR. JOHNSON. That trend is consistent with a decline in inflationary expectations I would think, so you're still left with that major question about velocity.

MR. PRELL. Mr. Chairman, I'd like to just note that L rather consistently has grown a little faster than M3 over the past 3 years and that the first-quarter pattern is the same again. It was one half percentage point faster over 1983; 1.4 percentage points faster over 1984; 0.8 points faster in 1985; and 0.7 points faster in the first quarter. So the trend really isn't any different thus far this year.

CHAIRMAN VOLCKER. Well, let's have a break.

[Coffee break]

CHAIRMAN VOLCKER. I'll make a few comments, which may be more in the nature of a summary. I must say when I gaze at this table of the first quarter that Mr. Kichline gave me, if you believe the numbers--which is a big "if" for many of these quarterly figures--from one perspective it's quite a remarkable performance to have an increase in the GNP at a 3.7 percent seasonally adjusted annual rate during a quarter when federal purchases are going down at a rate of 30 percent and plant and equipment [spending] is going down at 13 percent. If I recall, those things are temporary; there must have been some strength elsewhere. I guess one could raise some questions about how sustainable the inventory figure is. But that doesn't seem to be in accord with what we've been thinking about the economy. However, if you average the fourth and first quarters, I guess you have a picture that's more in keeping with what we thought was going on, or is probably more accurate--a little over 2 percent. We had a description of a very mixed picture of different sectors of the economy and different sections of the [country]. Manufacturing remains somewhat in the doldrums; we have a few excesses developing in New England and elsewhere in the country in all those financial operations. When I look at the problems, generally, I'm not sure there's much that is correctable--looking at it on a world-wide basis now--by much change in monetary policy. This trade situation that has been talked about, I think, is a very serious question. But it's hard to see how it could be corrected by monetary policy in the United States; maybe it could be corrected by monetary policies in Germany and Japan. But I'm among those who are a little skeptical unless we get more growth abroad, because I think that's what's needed to improve the trade picture.

I might say a word about the LDCs. I don't think that's going at all well at the moment for a variety of reasons, mainly in Mexico where the political situation has gotten very difficult--stimulated in important ways by expressed American attitudes toward Mexico with regard to drugs and corruption and all that business. The atmosphere is very foul for getting constructive changes in economic policy. And they're going to run out of money one of these days. They haven't yet; their reserve positions have been pretty well maintained, I think, probably by very tight money and exchange rate changes. The degree of the tightness of money, at least, probably isn't very good for their longer term. The economic policy mix is not very good for what you'd like to see happen constructively over time. In the political atmosphere I think there is a question as to whether they will be successful or even want to get their act together to do a constructive financing. And if they don't do it, there will be very serious problems in the rest of Latin America. Again, I don't see that this is susceptible to monetary policy at this point; a moderate change in interest rates isn't going to do anything for the political situation, which is the root of the problem.

It has been remarkable, I think, that the domestic financial pressures in Texas and Oklahoma that should be there aren't very visible on the surface. We are learning--or we already have learned, I guess--how to run our savings and loan system without any assets. We're getting to the point of [learning] how to run a commercial banking system without any assets. Everything goes on faith. But again, I don't think there's anything there that's particularly susceptible to economic policy. We are getting the protectionism threat coming up again connected with the trade situation. All of this to some degree bears upon world-wide economic policy, but again, it's hard to see how it bears very much on monetary policy at the moment, given what we've done.

I had a little discussion about what the threat of inflation is. I find that we pretty consistently have underestimated the progress against inflation. But when I look at next year and the possibilities, I find it entirely plausible to say at the least that the inflation rate would rise quite a lot next year. I don't think that's certain; but I just think there are a lot of persistent price pressures in the service area and that's so big. One can list a whole bunch of services where that's true, including financial services and housing. We're going to get some impact of the dollar [depreciation]; that's icing on the cake. As for the energy situation, even if [energy prices] level off, that will be a different picture. But if they rebound at all, we will get another aggravation. I think we've done remarkably well so far on the goods side of the economy, but we're not going to have agricultural prices going down forever and energy prices going down forever. The basic wage and the basic cost on the manufacturing side look fine, but it's a pretty hard [unintelligible] effort on that services side of the economy. What we could hope for is that if [inflation] did come out around 4 percent or so--I don't know whether that will be right--but if it's during a period when we're absorbing the exchange rate change we might have gotten off cheap. Maybe it will be temporary. To a degree, I think that's what we've got to work for. We can't offset that potential inflation if the economy is strong, but we could work to make it temporary rather than permanent and hope to see a little more progress over time on the service side. I think we've got to look for protection there from the budgetary action, which I hope comes forward, and not let the economy get overly exuberant if things go in that direction. But none of that is certain yet.

On the monetary side I'm told that the preliminary news on the latest money supply figures is not better; in fact, it's a little worse. If anything, the May figure looks like it's going to get up toward 20 percent instead of anything lower than that. At the least it's an awkward looking figure. We have said all along, and I would continue to take the view, that the importance of all these measures has to be judged in the context of M2 and M3--to look no further than the monetary aggregates. They got stronger but they are not so overwhelmingly strong as M1 in terms of our longer-range targets; they don't look alarming at this point. If they begin leveling off--and their rapid increase is fairly recent and I guess it still doesn't look like that's going to parallel the semi-explosion in M1 in May. So I don't know. We have a few tremors; I don't think we have all the confirming signs on M2 and M3.

I don't want to prejudge things but I get the sense that the comments heard around the table were not forcibly in the direction of doing anything particularly to monetary policy at the moment. As we look out ahead--and maybe not very far ahead--the question of being a little more restrictive does arise. I'm not sure that date has come quite yet. It would await further evidence on both the monetary side and on the economy. There we are. What have you got to say for yourselves?

MR. BLACK. You pretty well have said it all, Mr. Chairman.

CHAIRMAN VOLCKER. You've got to be a little more specific than that! Mr. Parry.

MR. PARRY. I would choose alternative B, which I feel is consistent with growth of around 3-1/2 percent in 1987 and further declines in unemployment. It seems to me that alternative A is not as desirable because of my concerns about the value of the dollar and its inevitable inflationary implications. Also, if we were to choose alternative A, it would come in the context of already very favorable fundamental factors; those that we've mentioned would include lower interest rates, lower oil prices, a value of the dollar that is considerably lower than expected, and of course, the strong growth in M1. Alternative A does not appear to me to be consistent with a goal of longer-term price stability. Also, at this point I would not favor "C" because I think it runs the risk of not permitting good growth in 1987. On the other hand, my concern about the future direction of inflation and also the persistent strength in M1 would lead me to favor variant III of the directive. To inform financial markets that there is concern on our part about the growth of money would seem to make some sense.

The other point I'd just add parenthetically is that I can come up with a scenario where M2 and M3 may become somewhat more of a problem. Over the last 6 months to a year we've seen an awful lot of money going into mutual funds, stocks, bonds, and municipals, and when investors believe that the interest rates are going to turn those funds are going to come back to short-term assets. And if they come back short, they're going to go into M2 and M3 and we could see much faster growth in M2 and M3 at that point--primarily as a result of portfolio shifts. It would not necessarily indicate that people are going to be using these [funds] for transaction purposes. But I wouldn't derive a great deal of comfort by the well-behaved pattern of M2 and M3 at this point.

CHAIRMAN VOLCKER. Let me just say a word about these directives. One can debate the particular language but we are so far off the numbers in the directive labeled "alternative draft I," which is the same as the one we had last time, that that seems to me to be a kind of bare-faced evasion of responsibility. [We should be] reac to what has happened in a somewhat more sophisticated way than just putting in different numbers in the existing directive, which raises the question of what has been happening here. Mr. Keehn.

MR. KEEHN. Well, I'd also favor alternative B, largely for the reasons Bob stated. I came to the meeting wondering whether we might not fiddle with the words "might" and "would;" but based on the conversation I would not. I would make it symmetrical on both sides. I'd favor the second draft alternative. That seems to me a responsible way of dealing with the aberrations that we've experienced. I just have a slight fear that if we drop the numbers altogether, as called for in the third alternative draft, it might be a bit [unintelligible] for doing anything like that. We might save that for the July meeting. So, I'd be in favor of "B" with the wording proposed in the second alternative.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I came to the meeting with a couple of questions in mind and one was, though I agree with the staff forecast: Do I really believe it's going to happen? I also had a question about whether I should continue to believe in the lags that everyone keeps telling me are going to catch up with us one of these days. But I guess I come out feeling, for all of the reasons that were discussed before, that I probably should believe the forecast. Given that belief, I do think we are going to get the kind of growth that we are looking for. And that leads to another question which is: If we do in fact achieve that kind of growth, should we attempt to push the economy a little further to stimulate it more? I think that there are some dangers in doing that; I think that would tend to push us beyond the long-term trend of the economy. To me the risk at the moment is an overstimulation and the reigniting of inflation and inflationary expectatio As has been noted, we already have some dangerous inflation in the service sector of the economy.

So, having gone through that analysis I come out, as you would expect I suppose, for alternative B--not to change policy at the moment. I was struck, though, by the discussion around the table. We had some remarks earlier on that we are expecting this kind of growth but we are not really seeing it showing up in the statistics. It seems to me that we heard this morning that that kind of growth is perhaps beginning to surface, at least in some parts of the country. There was a lot of divergence, but at least in my own area--and I heard others say this--we are beginning to get some statistical evidence that the growth we're looking for is perhaps coming on line. So again, Mr. Chairman, I would choose alternative B with a 5 to 9 percent associated federal funds rate. And I suppose that would suggest to me a borrowing level of about $300 million. I too would like to have a directive that would take account of what has been happening to the monetary aggregates; I think not to acknowledge that overshoot would not be responsible. I had originally thought that the basic drafting of alternative I would be acceptable with the inclusion of the language about the monetary aggregates shown in alternative II.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I share the optimism about growth over the second half of the year and, as a result, the lack of good evidence at the moment creates an uncertainty that suggests to me that alternative B is the appropriate prescription for policy in the period ahead simply because we don't know what is happening and that alternative pretty much holds the current position. As to the directive itself, I would favor draft alternative II for the reason that there is a recognition of the rapid growth in the aggregates that has already taken place and that we would expect through the second quarter. And it places M2 and M3 first, with simply a recognition following that of the M1 growth. Lastly, it does suggest or maintain the idea that some firming could take place in the future given that rapid growth, if the economy begins to perform as we would anticipate and the pressures begin to show up in prices. All those things to me seem to be consistent with (1) what we think and hope the outlook will be, and (2) a realization that M1, M2, and M3 are outside [their ranges] and that the numbers are somewhat different than last month, but nonetheless we maintain them as guideposts.

CHAIRMAN VOLCKER. They're somewhat different all right! That's an understatement of the situation.

MR. GUFFEY. Well, draft directive III has no numbers in it at all with respect to any of the aggregates. I think that's a rather marked departure from what we've done in the past and one that I would not feel comfortable with.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, as you indicated in the beginning--and I think you pretty well said it all--the economy is being pulled in a lot of different directions. And it seems to me that this is a time when perhaps we should stay about where we are. Looking at the economic factors, there doesn't seem to be any reason for easing if we're half-way right in our assessment of what the economy is doing. And M1, as we know, has been going through the ceiling and now the broader aggregates seem to be picking up a good deal. We have these special problems with particular sectors like agriculture and other manufacturing, but as you pointed out those are not things that we can address very well with monetary policy. If we tried to nudge the dollar down, for example, it might well backfire on us and we'd really achieve no improvement in our balance of payments. So, I've come down to the point that I think we ought to stay about where we are. I would go with "B," although in the absence of a sharp deceleration in economic activity I'd be real happy if the aggregates came in at "C" or even below that. But if we get a clear signal that activity is beginning to accelerate beyond what any of us seem to expect and if the aggregates also are strengthening more than we anticipate, then I think we're going to have to be prepared at some early point to think in terms of moving in the direction, anyway, of restraint. I would not say restraint, but in that direction. I think alternative III--and this probably will surprise most of you, knowing my past views--really captures the posture. I think we ought to take it at this point; I hasten to add, however, that I would want to reinsert the short-term numerical targets for the aggregates when we get around to addressing the longer-term aggregates at our July meeting.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. I'd be in favor of maintaining the existing degree of restraint right now but I definitely would have a bias in the direction of a somewhat firmer policy. In other words, at this point in time, I think it's more likely that we will have to firm than ease, as you said earlier. What concerns me is that there is always the possibility that when we see the "whites of their eyes" it will be too late. I am not sure that this is the time to begin to get some [unintelligible] back in, but we may be getting close to that time. And I would be particularly concerned if we did see some pickup in economic activity and that didn't flow through to a firming in the dollar; I think Sam said before that the trend in general still seems to be downward. That would concern me--if there really came a time when almost no matter what we did we couldn't easily turn that tide. In any case, I would be in favor of the existing degree of reserve restraint, but would favor language that would indicate something other than symmetry--language that would indicate possibly moving toward a firmer policy down the road.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. First of all, I gathered from trying to piece together a few comments in the Bluebook and the Greenbook that the staff views at least the upper end of the M1 target as being consistent with the GNP forecast and that that can be achieved at roughly today's interest rates. So that implies a significant slowing in M1 over the balance of the year without any action on our part. If all of that is right then I, too, favor alternative B. As far as I can judge, it will take us about where we want to go. I do think, as others have commented, that the directive language perhaps matters a great deal this time around. I have a strong preference for the third alternative principally because, at least in my mind, that is the clearest statement of what we intend to do if growth in the aggregates doesn't slow as expected; and I think it's probably important to make that point. I also think that we can insert a sentence in there with some numbers if that's desirable; certainly that's doable. I am a little concerned about the language in there having to do with lesser reserve restraint because it points to things like slowing money growth or the foreign exchange markets whereas I think that slowing money growth and a stronger dollar might at least in the short run be more than welcome. I am not sure that I would want to respond to that. Beyond that, it also refers to sluggish economic performance and I think we have largely conceded that growth in the second quarter at least is going to turn out to look kind of sluggish--real growth of 2 percent, given the adjustment that is still going on in the energy sector and so forth. So I would be a little concerned about that kind of language--that such developments might prompt a policy response, and I don't find that appropriate at this juncture.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I think alternative B is the right policy course given the mix of hopes and anxieties and uncertainties that we face. As to what we do about an M1 that has blown out of its targets: I think we do have to acknowledge it, and I think something along the lines of variant II for the operational paragraph is right. To go all the way to variant III I think is premature. We will be having a meeting in July in which we will have to reevaluate the aggregates for the second half of the year. It may be prudent at that time--or it may not be--to change the target ranges. It may also be appropriate to acknowledge a different weighting; but it seems to me that a mid-quarter meeting is not the appropriate time to do that. So, I would acknowledge that [monetary growth] is over the target and then have a more fundamental look at the normal point in the calendar in July. There is also the advantage in July that [your Congressional] testimony would be following our decision fairly promptly and whatever we do can be wrapped around the appropriate words.

CHAIRMAN VOLCKER. Mr. Morris. Mr. Morris has stepped out. Governor Angell.

MR. ANGELL. I also favor alternative B and I prefer draft II. I would want to be a little clearer on the fourth line of draft II to say rapid M1 growth and weakness in M1 velocity. I am not sure that M2 is rapid when it's right in the middle of our range and expected to be in the middle of the range. I do believe, however, that there is another immediate policy move that needs to be made to reflect the weakness of the dollar and the undesirability of further weakening of the dollar at this point. I would think it would be just ideal if the Chairman could negotiate with the Secretary of the Treasury so he would be willing to have intervention on behalf of the dollar, provided the Japanese and Germans cut their discount rates 1/2 point. So, I would like to see something take place in this environment; and I think that would be a step that would be helpful to everyone.

CHAIRMAN VOLCKER. Why don't we discuss the attitude toward intervention a little after we get finished with this instead of mixing it up. If you want to discuss it, I think it may be a good idea. We will reach this decision and then discuss that. Mr. Morris.

MR. MORRIS. Mr. Chairman, I also support alternative B but for different reasons, it seems. The stronger growth projected in the second half is really entirely a function of the improvement in the trade balance, and our ability to forecast the timing and magnitude of changes in the trade balance is not so great that we can have confidence that we can forecast it extremely well this time. If we don't get a third-quarter improvment in the trade balance, I think we will continue to have a pretty sluggish forecast. I don't see anything else that is going to pull the economy [up] very rapidly. So, I don't think we can move on the anticipation that the third quarter is in the bag yet. As a lot of people have said, we have to see the whites of the eyes of this narrowing trade deficit.

I question whether we are in fact putting excessive liquidity into the system now. I proposed, when we were last talking about the long-range targets, that we set targets for M3 and total liquid assets; I assumed a minus 1 percent velocity for 1986. As I look at the fourth-quarter [and] the first-quarter rates of growth that would be compatible with a growth of 6 to 6-1/2 percent for nominal GNP I don't see that; the only thing in the picture that would lead one to think that we are building excessive liquidity is M1. I am not very sure that we understand the meaning of that growth of M1 for future economic growth.

On the inflation front, I am more optimistic I think than many around the table, but I have been looking at what I call the "core" inflation rate and that is the price indexes eliminating food and energy. If you do that, you see that there hasn't been any deceleration in the inflation rate in 1985; and if you look at the projected inflation rate for 1987, it doesn't look at all bad because it is not much different than the core inflation rate now. It just depends on what set of numbers you have gotten used to looking at. I think quite clearly the recent sets of numbers for the CPI and the wholesale price index had a lot of one-shot effects from food and energy that are not going to be repeated; we have to understand that this is an aberration. And when the inflation rate gets back to the core rate, we shouldn't be too much alarmed because that was the fundamental situation all along.

With respect to the directive, I appear to be the only one favoring draft directive I. The reason is that it seems very clear to me that when we meet in July, we're going to look at the growth rate of M1 and either we will have to eliminate M1 as a target or rebase it again. I think that is clearly in the cards. And if that is the case, I don't see any reason to equivocate in letting the market know what they already know: that we are discounting M1 in monetary policy. I don't think we kid anybody if we think the market feels otherwise. I don't think we can tell the market a different story with a [different] form of the directive than the former directive because I don't think we really mean it. Are we really going to tighten up money and tighten up interest rates in a sluggish economy in order to get the M1 growth rate down? If we are not, then it seems to me it's time to recognize that fact; and it seems to me directive I is an ideal way of beginning to do that.

CHAIRMAN VOLCKER. You leave me totally confused, if I may say so. I would think the thrust of your comments would lead you to want to change directive I.

MR. MORRIS. Well, directive I is where we talk about the expected rates of growth of M2 and M3 and it has language, which comes in after that, to the effect that the growth of M1 is uncertain. That suggests to me a downgrading of the significance of M1.

CHAIRMAN VOLCKER. People can read the same thing differently, but I think the interpretation of keeping alternative I would be that nothing has changed in relative emphasis because we haven't changed the language. If we want to change the relative emphasis we would change the wording of the directive. The [draft] wording may not be perfect, but--

MR. MORRIS. Well, I would be happy to make that suggestion also. If you accept the proposition that we are going to have to do something in July, it seems to me to make sense to start doing something now.

CHAIRMAN VOLCKER. I don't want to argue the point in substance. All I am saying is that if you want to make a change, I would think that the last thing you would want is the old directive repeated again, which says we are not changing anything.

MR. MORRIS. Perhaps I inferred that drafts II and III imply that we are going to give a lot more emphasis to M1.

CHAIRMAN VOLCKER. I don't think they're implying that.

MR. MORRIS. Well, maybe these things are getting so obscure, Mr. Chairman, that we ought to decide what they mean.

MR. ANGELL. I think that's pretty close to the truth.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. Well, I would support maintaining the existing reserve pressure but I have the same problem with the alternatives presented today as I did a few months ago, and that is that there seems to be so little difference among them. I would like Bob Parry to give me the model that shows the impact in 1987 of a difference in M1 growth in this quarter of 3/4 percentage point at annual rate between "A" and "B" and another 3/4 percentage point between "B" and "C," and 1/2 percentage point between the alternatives for M2, and 1/4 point between those for M3. I would like you to tell me how those marginal changes will impact on inflation, trade, auto sales, housing, etc. in 1987. I think these are very, very, tiny differences. As I say, I'm totally willing to go with maintaining the existing reserve pressure; but "A" doesn't send a message to me that it is a big change in the easing direction, nor does "C" seem like a big change the other way, particularly when we are talking about [a quarter point on these] numbers. Maybe I am missing something or maybe you are hiding those equations from me, but I haven't seen that kind of forecasting ability around here. Anyhow, in terms of the problems in the economy, as I said, I doubt that "A," "B," or "C" will solve our trade problems immediately or take care of manufacturing or third world debt or all of the other ailments we talk about. So, for that reason I will stick with the status quo. On the directives, again because we are going to take a fresh look at this in July, I would just go with alternative II.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. I also would agree that alternative B is the right approach. However, I generally agree with what Frank was saying on the directive. I don't know exactly what the right language is, but I would prefer to be as neutral as possible on the directive. I certainly wouldn't want to acknowledge the growth of M1 at this point because right now we are still trying to determine whether that growth is a response to the decline in interest rates and whether the demand for money might lead us actually to want to increase bank reserves, rather than cut back on the growth of M1, to accommodate a further shift in the demand for money--at least an increase in the quantity demanded because of some [unintelligible]. I certainly wouldn't want to send out the red flag about the fact that we're concerned it is growing too fast when we don't even know yet whether this is a portfolio shift or whether what's going on is a result of declining interest rates and inflationary expectations or whether it is something to be concerned about. There are only six weeks before the next meeting, and I'd say we certainly don't have to get stewed up about the aggregates when we can address this whole issue very carefully in July. We can decide then what we are going to do about the targets when we have a better chance to judge whether anything is happening to the economy as a result. Right now all around the table we have said very clearly that nobody sees any strong evidence that anything is going on. We're still in this 2 percent pattern. We are all hopeful with regard to the forecast, I agree; I too am optimistic about the second half of the year. But until we get a little evidence at least in the orders data--or something to indicate that there's a pickup--I would like to remain absolutely neutral in the directive about where we want to go. I wouldn't want to send out any signal whatsoever to the market at this point. I would wait six weeks and see what we want to do then. That's when we ought to have a little more time to decide whether the second half of the year is going to be the kind of situation we are hoping for.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, I also would agree on alternative B for all of the reasons that were given. On the directive, I agree with Frank and Manuel's point of staying neutral; it seems to me that alternative III does that much more than alternative I, as was discussed earlier. It does not use numbers; it's very straightforward. In fact, it says we don't know. We do have July coming up and that's a traditional point at which we take a new look at this. This [directive] would not become public until after the July meeting, which I assume would be pretty close to the time that you would be testifying. You would have the opportunity to explain it all. It seems to me this signal of not putting any numbers in right now, as in draft directive III, is the best indication of consistency, [acknowledging] that we are a bit confused. And it seems to me it gives you the opportunity to say whatever needs to be said come July. I would very strongly go with option III.

MR. JOHNSON. My only concern about that was that it implied that we might have lesser reserve restraint if there was a marked slowing in money growth. I would say that we're so uncertain about the money demand situation that I wouldn't want to imply that we would ease if money growth slowed--even substantially. If we take out any response to the aggregates, I would be happy with that.

MR. PARRY. Are you saying that if money does not slow at all over the next six weeks and we have continued [high] growth rates, that you would not be of a mind to make a move?

MR. JOHNSON. That would depend on whether we are seeing something happen in the economy by then.

MR. PARRY. I think that's really where the difference is. I think there are some people who say they would. I think that's a difference of substance.

MR. JOHNSON. Well, everybody will have a different opinion. I am just saying that's my opinion. I would want to see if the economy was catching on as a result of this M1 growth that we have had. The base is not really doing anything. There has been big growth in M1 and I would like to see if that is catching on or if people are just deciding to save out of those other checkable deposits or what is happening. In July, [unintelligible] if things were really starting to catch fire--if orders data and leading indicators were looking a lot stronger--I would say that would be a good indication that money was being used more for transactions than we had thought at this point.

MR. MELZER. You weren't doing this, but I think it's dangerous to draw a parallel between now and year ago when we had similar problems. The reason I say that is that interest rates are down a heck of a lot more than they were a year ago, the dollar is down, and oil prices are down. In a sense it's easy to slip into the mode, in general, of thinking that this is exactly where we were a year ago. I am not sure we are because of those other forces that are at work and what we may see down the road in terms of a possible resumption in inflation. In my mind, it may not be as easy this time around as it was a year ago, just from a market perspective point of view, to abandon the targets. But I guess that's for July.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, I think we ought to stay in a holding pattern and that means I favor alternative B, like everybody else. On the directive, I favor alternative II. I also favor being neutral. And I see no conflict in being neutral with allowing the market to know that we acknowledge what's happening with the aggregates without making a judgment; we just let the market know that we know this. I think not to do that would risk giving the wrong signals. So, I would prefer alternative II. While I think we now are probably closer to the time when we may feel some need to snug up a bit, I would be careful not to give any indication to the market that I felt that way, because it just might make it happen; it might give rise to something.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. Like Mr. Parry, I am not so sanguine about M2 and M3; and I guess the greatest concern that I have is really even more with M3, where for Bob it was M2. The concern that I have about M3 relates to this question that Frank raised about liquid assets or whatever you call it. We have a situation right now where there has been a tremendous burst in longer-term financing; but we also have a situation in which there has been a tremendous burst in both intermediate- and short-term financing as well as the long-term, through which the banks' role in that process is one of a contingent source of liquidity through standbys and guarantees and [unintelligible] and all of these other things. So, one of the reasons M3 looks so sanguine and indeed why liquid assets, or whatever that is called, look so sanguine is because the nature of the relationship of the banking system to this process is different. What is there now is a very substantial and very rapidly growing contingent liquidity [unintelligible] on the banking system. And I think that is something that bears on the way in which some of these broader measures of liquidity and financial expansion look. So, I put that on top of Bob Parry's earlier argument. I for one am not so sanguine about what M2 and M3 are telling us, and I am of the view that when we take account of conventional liquidity plus what I would loosely call contingent liquidity that we have kind of a paradox in that the contingent liquidity--what [financing] could have to be produced--doesn't show up in a lot of the conventional measures we are used to.

Another quick point: Though none of us may be very impressed with M1, and I am not either, I think it's worth noting that for the first time in months and months and months, people in the market are looking at M1 both in the United States and abroad. Nobody is getting alarmed or anything like that, but there is a change in that people are looking at it again. They are not reacting to it but they are looking at it, and I don't think we should kid ourselves about that either.

As far as policy is concerned, I would certainly very much put myself in the "B" camp. I also have a little bias in the direction of the need to be more sensitive to the possibility of "B" with a bit of a bias toward greater restraint, or "C." I don't know what is going to happen between now and the next meeting either, but I certainly could envision a set of circumstances in which even in that intermeeting period we might feel the need to snug a bit. Because I feel that way, I favor directive III. I think directive III, with a couple of modest word changes, can be made compatible with the point that Governor Johnson made, which I think has some validity, by making the first conditional sentence something like: "If such a slowing does not develop, somewhat greater reserve restraint would, or might, be acceptable in the context of a pickup in economic growth" and putting a reference to the monetary aggregates in there. But the part that is more important to me is the somewhat lesser reserve restraint sentence. The <u>only</u> thing that would move me in the direction of somewhat lesser restraint that I really can think of right now would be if the balance of the quarter materialized in a way in which the economy itself were distinctly sluggish. So, I would either want to get rid of the lesser restraint sentence altogether or just have that sentence limited simply to a distinctly more sluggish economy rather than all of this other stuff.

MR. JOHNSON. That was exactly the point I was trying to make. If the economy were showing a lot of strength--even if M1 dropped off quite a bit and it indicated that the velocity really would rebound sharply--we wouldn't want to ease under those conditions. I agree with that, but the opposite applies too. The economy could be growing strongly but if velocity were showing continued weakness, we wouldn't necessarily want to tighten.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. I favor alternative B and the number II statement of the directive, although I could take number III with both the suggestions that Jerry has made with regard to saying something about the aggregates. That is why I mildly favor II: because I don't want to indicate at this point that we are turning our back on the aggregates or that we are not being watchful of them. I also agree about the change in the sentence on somewhat lesser restraint, because

I do think the one thing that could happen that might make me want somewhat lesser restraint would be a remarkably sluggish economy.

CHAIRMAN VOLCKER. Governor Wallich, you can interrupt all this unanimity for Alternative B.

MR. WALLICH. Well, I don't have much [to say] for the "B" notion because of the problems about the situation. People are unsure about [unintelligible], and that is particularly the situation--when one feels unsure about the sensitivity of what one is doing--where it is better in that moment simply to go to "C." I know this could have a bad effect, but initially it will reduce some of the errors that one might make if one began with "B."

CHAIRMAN VOLCKER. You want to tighten up a little?

MR. WALLICH. Yes, and I have had a hard time coming to this.

CHAIRMAN VOLCKER. Okay, with that exception, the easy part is alternative B. The difficult part is what that means. I have heard considerable expression that the wording of the directive ought to be changed, with only one exception. We have to look at these carefully to see what the difference is. Just to speak for myself, I am not sure I am alarmed--if that would be a fair way to express it--over M1. Three consecutive months of high numbers do give me a little pause, however much I deemphasize M1. Even if I don't pay any attention to it at all, this is a time for a little perking up of the ears anyhow, particularly with some rumblings [unintelligible] in M2 and M3, although not at a serious level as yet. I also have to agree that it's very hard to see what would make us ease during this period except reasonably clear signs of softness in business activity. To see M1 falling below the particular M1 number would not impel a great easing at this point with nothing going on in the economy. However--

MR. RICE. Who needs much more than 20 percent growth?

MR. JOHNSON. I bet we could. I wouldn't want to, but I think we could.

CHAIRMAN VOLCKER. We'll see what the salient differences are in these directives here. The first sentence is going to be the same anyway--"maintain."

MR. BOEHNE. I wonder, Mr. Chairman, if I might make a suggestion as to something that might make most people happy? It seems to me that most people want some acknowledgement that M1 is overshooting but people--at least the majority--also want to be totally neutral about what we might do, in order to not tip the scales one way or the other before the July meeting. One way to achieve that would be in--

CHAIRMAN VOLCKER. I don't accept that as a premise.

MR. BOHNE. All right. Well then, there is no use having what I suggest.

CHAIRMAN VOLCKER. The Committee may decide that, but I didn't think there was necessarily all that much unanimity that under no conditions would we change--

MR. BOEHNE. Not under no conditions. What I meant was that at this point we just don't bias the directive one way or the other.

MR. JOHNSON. I do agree with that point. If we acknowledge the overshooting of M1 growth, which may be appropriate, I think we at least ought to balance our acknowledgement of the growth of M1 with the two possible meanings associated with that growth. One is that we have a big bulge in money demand for various reasons associated with lower interest rates, declining oil prices, and all those things. But it also can mean the opposite; it could be a warning of too much liquidity. We don't know right now, it seems to me, which one of those meanings to apply to it.

MR. BOEHNE. Well, I think Governor Johnson is right. One way to deal with that is just to drop the sentence at the bottom of page 12 in draft alternative II that says, "This action is expected to be consistent with a deceleration in money growth over the balance of the quarter." If we just take that sentence out and then in the next sentence drop "however," it simply acknowledges that we have had rapid growth. Then we could follow the numerical specifications by saying "somewhat greater or lesser reserve restraint might be acceptable" etc. It seems to me that that says: Look, we have overshot M1 and we are not sure what it means; we may respond one way or the other, but we are not at this point saying which way we might go. We will wait until developments unfold.

CHAIRMAN VOLCKER. If that's what we wanted to say, that's the way to say it. But I think a lot of people would not say that.

MR. PARRY. I think I wouldn't want to say that. What I would want to say is that if money continues to grow, I have a concern. I think you're saying that if money continues to grow you don't have this concern until you see some other things occurring. I am not so sure that I could support that.

MR. JOHNSON. Well, we were just making an offering.

CHAIRMAN VOLCKER. There are a zillion contingencies as usual, but just on this point, I guess there is a question: If monetary growth continued at the recent rates--I'm talking about all of the aggregates now--with M1 averaging about 15 percent if we use recent months, and M2 projected now for the second quarter at 9-1/2 percent and M3 at 8-1/4 percent, are we highly neutral about those growth rates or not? We had 13 or 14 percent growth in M2 in April and 11 percent in M3. Are we really saying that if growth continued at that rate of speed, just looking at the monetary aggregates alone, that we're neutral?

MR. PARRY. Well, it depends on what happens to the economy.

CHAIRMAN VOLCKER. All other things equal at this point.

MR. PARRY. But even there I have a problem because these are not contemporaneous events. If one is expecting the real developments to follow what has happened with regard to the aggregates to some extent, then if we are waiting for that kind of confirmation and it occurs, we may have to do a lot more later than we would like to do.

MR. JOHNSON. Bob, I agree with what you are saying, but I am just asking: How long have we been sitting around here waiting for the lags now? We have been watching.

MR. PARRY. It's obviously closer.

MR. JOHNSON. I don't know whether we are closer or not.

CHAIRMAN VOLCKER. I don't know how close we are, but I do know that these rates of growth of the aggregates have picked up substantially from what they had been.

MR. ANGELL. Isn't there some point in time that the M1 growth path in and of itself gets to be fast enough? Particularly if we are moving down the demand curve due to the interest rate declines, I would expect that at some point in time--that is, if interest rates don't drop--we ought not to be getting that kicker any more, so we would expect M1 to decelerate. It seems to me that it's more logical that M1 is going to decelerate. The question is: How much? I guess I would like to have Jim's comments on that. How long after we bring interest rates down do we expect to get the quantity demand response just due to the lower interest rate?

MR. KICHLINE. Well, I think Don has the econometric results that we used. There is a lot of uncertainty, but we have various models. You are looking at the numbers, Don.

MR. KOHN. According to the models, for what it's worth, the interest rate effects would be expected to begin tapering off to a certain extent in May but mostly in June and then even more going out. We are not sure that the models have captured the interest rate effects all that well, given that we're at levels of opportunity costs that we have just never experienced before with respect to NOW accounts. But certainly the pattern ought to be one of tapering off, and that's what we built into the paths.

MR. ANGELL. Let's say you estimate that 5-1/2 percent of the M1's recent path might be explainable simply by the interest rate response. That response is going to disappear at some point in time.

MR. PARRY. Governor Angell, I think we all agree that if money begins to grow more slowly, we would have some degree of comfort in that. I think the first issue, and one where we seem to have some disagreement, is what if it doesn't? What does that imply in terms of what we say and do?

MR. ANGELL. I want you to understand that if M1 begins to grow slowly, [unintelligible] if we get it down to the 5 percent path after we have been at 15 percent and we don't see any evidence. We can do all the talking that we want to about the economy's growth path, but the hard evidence is that the economy is still on a 2 percent real growth path. That's all the hard evidence we have. If we don't have any evidence and we get into the third quarter and the third quarter still looks like 2 percent or drifting to 1-1/2 percent or slower growth, we've got to ease.

MR. PARRY. Of course.

MR. JOHNSON. Unless the inflationary picture--

CHAIRMAN VOLCKER. [Unintelligible] to hear you say that. I don't know what the growth path is, but frankly I'm not sure there is all that much difference between II and III. The first point we may consider is: Do we expect whatever action we take here, which is not much change at the moment, to be consistent with a deceleration of money growth? That's what we are told, as a simple forecast; and I guess we would like to see it happen. If that doesn't happen, we might tighten, depending upon the strength of business. That's the most important thing. I think that's what people are saying; but it is dependent upon the strength of business.

MR. JOHNSON. The nub of the problem is that everybody starts guessing what growth rate that means. What's the third-quarter number that will make us do that?

CHAIRMAN VOLCKER. I wouldn't rely upon a third-quarter number which nobody knows.

MR. JOHNSON. Well, I agree. That's what I am saying.

CHAIRMAN VOLCKER. We'd need a variety of hard evidence--say, some pickup in orders, continued strength in housing, and automobile sales continuing strong. With regard to the projections of next quarter's GNP there's a certain amount of skepticism, although these current indicators tend to get reflected in those projections. I am not talking about fine tuning the language. It needs to be fine tuned, but I would have thought that you captured the essence of what people were saying. Yes, we do expect a deceleration [in monetary growth]; if that doesn't develop, we are going to be a bit worried but we are not going to be worried enough to change things unless the deceleration is accompanied by some feeling that the economy is [not] doing reasonably well. And the only thing that would make us ease, as near as we can see now, is a clear sign that the economy is not doing well relative to current expectations. If that is the essence of what we are saying we ought to be at both II and III have the [prima facie evidence] of that, or more than the [unintelligible].

MR. GUFFEY. It seems to me that there is only one issue, Mr. Chairman, and that is whether or not we want to maintain some range for the aggregates, particularly as set out in alternative II--keeping M2 and M3 as the first targets and indicating that M1 is sort of uncertain.

CHAIRMAN VOLCKER. Well, that could be incorporated in III. The difference in the wording as it starts out is not much in substance, as near as I can see.

MR. PARRY. To me the phrase "if such a slowing does not develop" was the one that made the difference.

MR. MORRIS. The one big difference is that I read III to mean that we are reemphasizing M1, because in last month's directive we emphasized M2 and M3 and then we noted that M1 was uncertain.

CHAIRMAN VOLCKER. I don't think it was meant to reemphasize M1; it's a recognition that M1 is the one that is growing at a jet propulsion rate of speed.

MR. GUFFEY. I read III as Frank does--that M1 is in some way elevated.

CHAIRMAN VOLCKER. We have two different things: what's the inherent rate of M1, which I don't think anybody is intending to change here, and what is way out of line with respect to what was expected, which clearly M1 has been. It's like price and income effects. It's a low-weighted aggregate way the heck out of line.

MR. ANGELL. It seems to me that we could make some progress if we decide which draft we want to alter. Draft II has the aggregates mentioned and I slightly prefer to have the aggregates mentioned. If we start from draft II, then let's make the changes. If everybody wants to start from draft III, okay, but I don't think we can work from both of them at the same time.

CHAIRMAN VOLCKER. Well, I think you're probably right. Let's start with one or the other; I don't think that there is that much difference. I can alter in either direction.

VICE CHAIRMAN CORRIGAN. We can put in anything we want with the numbers. What matters to me is the kind of contingent operational approach between now and the next meeting.

CHAIRMAN VOLCKER. Do you want to start on II?

MR. ANGELL. Yes.

MR. JOHNSON. I am not really picky anymore. I would be worried if this were to be released immediately.

CHAIRMAN VOLCKER. The first sentence is "maintain. Then "This action is expected to be consistent with a deceleration in money growth over the balance of the quarter." That's a statement of fact. The next sentence is a simple statement of fact too. We could say "In view of the rapid money growth thus far in the quarter and apparent weakness in velocity, the Committee anticipates faster growth in the monetary aggregates [than expected at the last meeting], particularly for M1."

MR. ANGELL. That would be fine.

CHAIRMAN VOLCKER. Now, what numbers are we putting in there for M2 and M3?

VICE CHAIRMAN CORRIGAN. Alternative B would say 10 percent and 8 percent.

MR. KOHN. Well, alternative B says 10 percent and 8-1/2 percent for M2 and M3.

VICE CHAIRMAN CORRIGAN. 8 to 10 percent.

MR. ANGELL. Alternative B says 10 percent; it would have to be 9 to 11 percent.

VICE CHAIRMAN CORRIGAN. M2 and M3 are expected to expand at rates in a range of 8 to 10 percent.

MR. ANGELL. That's all right.

CHAIRMAN VOLCKER. There is a slight peculiarity in that it says M2 and M3, and as it works out M3 is expected to be 8 percent and the 10 percent is for M2. If we put in 8 to 10 percent, it sounds just the opposite according to this.

MR. BLACK. 10 to 8 percent!

VICE CHAIRMAN CORRIGAN. The broader aggregates are expected to expand.

CHAIRMAN VOLCKER. Would we say M3 and M2? This says "respectively;" you didn't mean that. We want to take out the word "respectively." M1 growth at an annual rate of--

MR. ANGELL. 12 to 14 percent.

CHAIRMAN VOLCKER. Are [unintelligible]?

MR. PARRY. That is one of the nice things about alternative III.

MR. RICE. Are you changing your mind?

MR. PARRY. I never was off it.

CHAIRMAN VOLCKER. Growth at the fantastic annual rate of--. Have we ever had a quarterly growth rate that big?

MR. ANGELL. Yes.

MR. MELZER. Nothing ever got written down this way.

CHAIRMAN VOLCKER. What did you say?

MR. ANGELL. You had that happen in 1980.

MR. MORRIS. Why don't we say "The behavior of M1 continues to be subject to unusual uncertainty."

MR. ANGELL. "Unusually rapid growth."

CHAIRMAN VOLCKER. This illustrates the problem of--

MR. JOHNSON. It grew about 13 percent all year last year.

MR. ANGELL. No, 12 percent; it was 11.9 percent.

MR. JOHNSON. Okay, 12 percent.

CHAIRMAN VOLCKER. What is it?

MR. ANGELL. 12 to 14 percent.

CHAIRMAN VOLCKER. 12 to 14 percent appears big [unintelligible].

MR. ANGELL. There is no use denying it; it's there.

CHAIRMAN VOLCKER. Well, the real problem is the next two sentences.

MR. MELZER. With those kind of numbers there, I don't see how we can give it symmetrical treatment.

VICE CHAIRMAN CORRIGAN. Even with those numbers, I don't see it as symmetrical.

CHAIRMAN VOLCKER. Well, let me just suggest that we pick up the two sentences with some modifications from the other directive, and say "If the anticipated slowing in coming weeks does not develop, somewhat greater reserve restraint would or might be acceptable in the context of a pickup in the growth of the economy, taking account"--keep the rest of that. Then "Somewhat lesser reserve restraint might or would be acceptable..."

MR. MORRIS. Why don't we just eliminate that, Paul? Why do we need to talk about less reserve restraint? I don't think that is one of the options we are considering now, is it?

CHAIRMAN VOLCKER. Well, that is all right with me if it is acceptable to others. I don't know; some people may want to put it in there.

VICE CHAIRMAN CORRIGAN. I'd only want it in if it is limited to more sluggish economic [activity] or something like that. I would prefer it out, but if it were limited to "lesser reserve restraint might be acceptable in the face of a distinct slowing in the economy," then I could live with it.

CHAIRMAN VOLCKER. Let's work on the second sentence. "Somewhat lesser reserve restraint might be acceptable should there be"--do you want to leave in the marked slowing of money growth?

VICE CHAIRMAN CORRIGAN. Money growth could be zero and it wouldn't hurt my feelings.

CHAIRMAN VOLCKER. Would be acceptable?

MR. ANGELL. I am not sure of that.

MR. RICE. Me neither.

MR ANGELL. [Unintelligible] these aggregates [unintelligible] one path and it changed from 15 percent.

MR. RICE. Because of the vagueness of it, you don't know quite what it means. How much lower?

MR. JOHNSON. And for how long? If it were just a month or two, I could stand zero, but--

VICE CHAIRMAN CORRIGAN. In a six-week period, what is going to make you want to ease?

MR. RICE. I would be prepared to drop it.

CHAIRMAN VOLCKER. "Somewhat lesser reserve restraint might be acceptable in the context of a marked slowing in money growth and pronounced sluggishness of economic performance."

MR. ANGELL. That is right. That will be fine. I don't see what is wrong with the way that is stated. It says about the same thing. Slower monetary growth than unexpected, especially of the broader aggregates, and sluggish economic performance.

MR. PARRY. "Pronounced" makes the difference.

MR. MORRIS. How about using the word "only"? "It would be acceptable only in the context of--." ?

CHAIRMAN VOLCKER. Well, we could say "it would be acceptable only." Or "might" carries that.

MR. ANGELL. "And pronounced sluggish economic performance."

CHAIRMAN VOLCKER. Sluggishness of economic performance.

MR. RICE. Not "pronounced."

MR. ANGELL. I like that better--"sluggishness."

CHAIRMAN VOLCKER. Now the previous sentence.

MR. ANGELL. And a period after "performance," right?

MR. JOHNSON. Are you going to strike the rest?

CHAIRMAN VOLCKER. "Somewhat greater reserve restraint"--do you want to put "would" or "might" in there?

SEVERAL. "Would."

CHAIRMAN VOLCKER. --"be acceptable in the context of a pickup in growth of the economy." Presumably if we did either, particularly easing--well, I'm not talking about some very minor thing--but if we wanted to make any pronounced move we'd have a consultation anyway. Let's see now, reading from alternative II, "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. This action is expected to be consistent with a deceleration in money growth over the balance of the quarter. However, in view of the rapid money growth thus far in the quarter and the apparent weakness in velocity, the Committee anticipates faster growth for the monetary aggregates, particularly M1, than expected at the last meeting. M2 and M3 are expected to expand over the period from March to June at annual rates of about 8 to 10 percent. While the behavior of M1 continues to be subject to unusual uncertainty, growth at an annual rate of 12 to 14 percent over the period is now anticipated. If the anticipated slowing in monetary growth"--do you want to put in there "particularly M2 and M3"?

SEVERAL. No.

CHAIRMAN VOLCKER. "If the anticipated slowing in monetary growth does not develop, somewhat greater reserve restraint would be acceptable in the context of a pickup in the growth of the economy, taking account of conditions in domestic and international credit markets and developments in foreign exchange markets. Somewhat lesser reserve restraint might be acceptable in the context of a marked slowing in money growth and pronounced sluggishness of economic performance." And then we have to stick in a federal funds rate here. There is a question of whether you want to make that 5 to 9 percent, which is centered on the present rate. We haven't changed that [6 to 10 percent] forever.

MR. ANGELL. 5 to 9 percent.

CHAIRMAN VOLCKER. 5 to 9 percent sounds reasonable to me, but I think we ought to put something in the policy record that states pretty clearly that that in itself implies no change in policy, because the press picks that up as a change in policy. So long as we are clear about that: that this is a purely technical change to center it around the existing rate. I think all this implies no change, as we said. We aim [for borrowing of] around $300 million--recently it's been below $300 million--as long as these monetary aggregates are so strong. We are not going to move anything for some weeks unless something very unusual happens. If we have a combination of continued strong growth in money and clear signs, whatever they are, of some pickup in the economy, we might consider snugging up a bit. If that became significantly more than a $100 million [snugging], let's say, we'd certainly have a consultation. Is that all understood?

MR. ANGELL. Well, it seems to me that we are just not certain at this point what is going to happen. It seems to me as likely to be in one direction as another direction. If the economy does grow slowly--does not pick up from the 2 percent path--the bond market is going to know as soon as we do.

CHAIRMAN VOLCKER. Are we ready to vote?

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	Yes
President Horn	Yes
Governor Johnson	Yes
President Melzer	Yes
President Morris	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	No

CHAIRMAN VOLCKER. Okay. Now, we had some question about the intervention that we might discuss for a moment. Do you want to discuss this operational issue of yours, Mr. Sternlight? Somebody mentioned to me that you'd like to have a biweekly report.

MR. STERNLIGHT. If I may take a minute on that, Mr. Chairman. The domestic account management has been submitting weekly reports to the Committee since 1922, describing the week's open market operations and the market background against which they were undertaken. While not best-sellers, they have provided a useful current review and an important historical resource when researching past developments. Since going to the two-week reserve maintenance period a couple of years ago, it has occurred to us that a two-week reporting period would also make more sense. This would provide a more meaningful time interval on which to report how we've gone about meeting the Committee's reserve objectives which are set, of course, on a two-week time frame. Moreover, preparation of the report every second week should permit better use of staff resources to work on other assignments and possibly achieve staff savings. But I don't want to dangle any hopes on this score, Mr. Chairman. Committee members will continue to get daily reports on actual Desk operations and market developments and also a brief summary report sent out before each Committee meeting.

CHAIRMAN VOLCKER. To bring you up to date on one aspect of this dating from 1922: I don't remember just when, but when I was in New York I once thought that it might be a good idea to drop the weekly report altogether and just report for the intervals between meetings. But this is a half way [alternative]. It seems to make a lot of sense, but I--

MR. WALLICH. In some sense it would. I know not everybody reads it--not even I.

CHAIRMAN VOLCKER. Just out of curiosity: How many members of the Committee read it? [Secretary's note: Quite a few hands went up.]

MR. BLACK. All the time or just some times?

SPEAKER(?). Most of the time.

MR. JOHNSON. Once in a while.

CHAIRMAN VOLCKER. This is interesting. Well, I don't [unintelligible] for discussion. This seems not unreasonable. It passes conveniently into the reserve--

MR. ANGELL. Two weeks makes sense.

CHAIRMAN VOLCKER. It makes sense to do that. I think that the new schedule is accepted.

MR. JOHNSON. I might request a slightly less technical summary--maybe even just a one-page executive summary that would just sort of [unintelligible].

VICE CHAIRMAN CORRIGAN. There is another historical aspect of this that should be mentioned that the Chairman didn't mention.

There is more than one person in this room who at some point in his career had the responsibility of drafting the weekly report. What is interesting about that is that after having drafted it, no one was permitted to read it.

MR. ANGELL. Sounds appropriate to me!

CHAIRMAN VOLCKER. Well, let's discuss this intervention question a little. I don't know if you really want to be operational about this, but some sense of the Committee's mood, I think, would be useful. We have these concerns about the dollar from time-to-time, including quite recently, and the question of coordinated intervention to support the dollar arises. I think it is fair to say that historically, although the Committee has not been all that gung ho by and large, in many particular periods we have been more receptive to intervention on either side--certainly including for several years restraining the rise of the dollar--than the Treasury has been. I suppose one way of expressing this is that neither of us has chosen to act, although we have independent powers, when the other side has not been ready to act. If the other side is more reluctant than we are, we don't act. The most reluctant party has a natural advantage under those conditions. But the question has arisen at times, just as in the most recent context, as to whether there wouldn't be some usefulness in intervening. This question has not been pressed very hard. Governor Angell may have some opinions of his own; he had a more detailed proposal. But the question arises as to how useful you think this tool is and whether we should be sympathetic in the right conditions--meaning a weak dollar in these circumstances--toward perhaps providing some support for the dollar. It is probably not relevant right now in terms of our present decision, but at some time it may inhibit us from being as easy in monetary policy as we would otherwise like to be for fear of its effects on the dollar. We may not quite be in that mode right today, but we could be at some other time--even in the [near] future, if the second contingency sentence in the directive came to bear. How do you feel about that possibility?

MR. JOHNSON. Can I ask you to clarify something for me? I assume we are talking only in terms of sterilized intervention, since otherwise it would have a bearing on what we just did earlier.

CHAIRMAN VOLCKER. I hate to discuss this in terms of responding [unintelligible] sterilized or unsterilized intervention because I think we've got to make those decisions separately and ex post. The intervention may be unsterilized but not in the technical sense that the amount of the open market operation is governed by what we do in the foreign exchange market. It may coincide with a period of easing and in some broad sense you can say it was unsterilized. We have this kind of separable decision. The contingency that might arise--the one that I cited--is where we might be in at least a slightly easy mode and want to intervene in the opposite direction. I guess it would be more than sterilized; in that particular case, it would be--I don't know what the term is--"antiseptically sterilized." We would be putting money into the domestic market and taking it out of the foreign exchange market; we would be going in the opposite direction. Call it "sanitized" or "insulated."

SPEAKER(?). "Ultra-sterilized"!

MR. ANGELL. It seems to me that we might have some doubts about the U.S. economy, but there is a lot out there that tells us that the Third World is [unintelligible] debt. [Given] Japan's and Germany's growth rates, it seems it would be very desirable to have some further easing of monetary policy in Japan and Germany, and I just don't think we ought to give up. I don't think we ought to give them what they want, which is a little help on intervention, without getting a step from them. I am not willing to do it unless they make the move we want them to make.

CHAIRMAN VOLCKER. You are putting it in a negotiating context, which could arise, but I don't know whether I absolutely want to limit the question to that context. One of the difficulties in world economic situations generally is that appreciation in their currencies, in fact, tends to depress their economic growth in the short run. One other reason you get as much weakness there as you get is because their currencies have appreciated so much that their businessmen have not been as eager, at the margin anyway, to expand as they otherwise might be. And that tends to support an idea that goes in your direction, in terms of some kind of trade-off, at some point.

MR. JOHNSON. The only question I have on the point that you made is that you have to be clear what you mean. Does "some coordinated intervention" mean we are talking about a slight tightening of monetary policy here to support the dollar while they lower their interest rates? I am not sure we want to do--

CHAIRMAN VOLCKER. [Unintelligible] forecast. I am thinking primarily of intervention to support the dollar. If we were tightening monetary policy here, however slightly, one ordinarily would think narrowly that that might strengthen the dollar a little in itself and we wouldn't have to intervene. We wouldn't have any interest in intervening on that side. I think the more operational case, although it is not the case right at the moment, would occur if we were running quite an easy monetary policy or easing further, or if monetary policy were unchanged and the dollar was declining anyway, making them unhappy. We would be raising some questions ourselves; we might want to intervene to support the dollar. One could imagine circumstances--let's say we were tightening policy [unintelligible] or for other reasons the dollar was strengthening. I [don't] think that is immediately ahead, but who knows? We might want to intervene on the other side.

MR. PARRY. This intervention is not directed at some momentary instability in the market? You are talking about something to change the direction of the currency?

CHAIRMAN VOLCKER. I am not talking about massive operations. If we have a massive operation, that is another kettle of fish. Presumably we couldn't leave that alone anyway until [unintelligible]. I think of it more as a change in the kind of attitude we have toward intervention. One particular reflection of that might be if the situation arose the way I described; that might make it operational but there might be other contexts too.

MR. STERN. At the margin, another tool in the kit seems to me to be a good idea as long as it is going to be sterilized most of the time. I don't think we ought to expect a lot out of it, but it certainly may have some signal effect, sentiment effect, or something like that. It strikes me as a good idea.

MR. JOHNSON. I have no objections as long as it is consistent with the monetary policy agreed to by the FOMC. I would think that we would have to cash those chips in few and far between to make it a credible change. It would have to be a moment that was really creating the right psychological impression.

MR. MELZER. In a sense, to have any fundamental impact in the long run, it would have to be unsterilized and run fundamentally counter to the policy--in talking about the situation you described.

MR. ANGELL. The foreign exchange market may have been somewhat dominated in recent months by market uncertainty as to whether or not our policy leaders in the United States would prefer a lower dollar. It seems to me at this point in time, [given] the time lags that we have in regard to knowing what we have accomplished, that it is not a desirable move for us to have an appreciably lower dollar and [we should] take away that question of uncertainty. Right now someone thinks someone is going to try to push it lower. Just taking that away might create a more stable climate, which would give us more options.

MR. MELZER. You said we could take that away unilaterally. It would have to be in the context of the agreement with the Treasury.

MR. ANGELL. I think that's [unintelligible] maybe.

MR. MELZER. In which case there might be so much confusion--

CHAIRMAN VOLCKER. [Unintelligible] could have a big fight about it. More generally, putting the question operationally, there have been times in the past when, quite on its own, the Open Market Committee was not very eager to intervene and--to exaggerate a bit--had to be dragged kicking and screaming to the table. I don't sense that such an atmosphere exists now, under the appropriate circumstances, but I want to confirm that. That's just the broadest way to put it. A more active mode in which to put it is to take one example, one Wayne took: If we see a positive desirability of doing it if we can get something out of the [other countries], that is one possibility.

MR. BOEHNE. I think Gary has said it right. It is an extra tool in the kit. There may be times when we can use it in the best interests of the United States and we ought to do it.

MR. GUFFEY. But in very modest amounts.

MR. JOHNSON. I am still unclear as to what we mean by that. Does that mean that we would let the funds rate drift up through our active intervention to strengthen the dollar?

CHAIRMAN VOLCKER. Barring some other decision, I think we would conduct a net of open market operations, domestic and foreign, to meet whatever the Committee decided upon.

MR. ANGELL. Roger, I remind you that we don't have a great big stock of yen. We don't have as many as I would like us to have; I thought we should have bought more in 1984, but--. So, we are not going to intervene a whole bunch because we don't have that many yen to take profits on. But it might come time to take a little profit--

MR. PARRY. The purpose of this is to communicate to the market what we think--

CHAIRMAN VOLCKER. Well, that clearly would be one possible purpose; another would be the kind of thing that Wayne described. Independent of that, if we really thought the weakness of the dollar was constraining what we wanted to do in reserve provision, we might want to send out signals. Whether that would be very powerful or not we don't know. But would it be useful to send a signal that says: "Yes, we are worried about the dollar"? If we want to ease anyway, we could try to give ourselves room to ease by giving a counter signal on the dollar. It might not work.

MR. MELZER. That is the problem I have with it in the fundamental sense.

CHAIRMAN VOLCKER. Well, in some fundamental, theoretical, sense we would be moving in opposite directions. It might not work. But, given the importance of psychology in particular instances in the market, one can make a case for trying.

MR. MORRIS. In this particular market context, I think concerted intervention would have an impact--at least in my judgment, based on watching the market--whether it's sterilized or unsterilized.

MR. ANGELL. Well, at this moment in time, if the Japanese were to cut their discount rate 1/2 point, and the Germans cut theirs and we didn't cut ours and we said [unintelligible] at the same time, I don't think you'd have to worry about an impact. I think the markets would take note of it.

CHAIRMAN VOLCKER. Yes, that's easy. But in the other case, suppose they didn't ease their policy and we were still stuck and we wanted to ease or not tighten and the dollar was weak. Let's put it that way: We weren't very eager to tighten or we wanted to tighten as little as possible, and they are not doing anything, and the dollar is a pain--

MR. ANGELL. Oh, you might make the gesture. I'm not sure; you might change the psychology slightly for a bit, but--

MR. JOHNSON. Well, we'd only get away with this once in my opinion. And we'd have to do it in conjunction with some support statements by all parties, it seems to me, instead of--

CHAIRMAN VOLCKER. Well, that obviously would help. But we could--

VICE CHAIRMAN CORRIGAN. I'm not sure about that, as a matter of fact. If you take it to that extreme where you've got to have statements and all the rest of it, then it certainly only would work once. I think there probably are very narrow windows of opportunity when Mr. Cross can sneak in and out of the markets, maybe with some help from the Japanese or something without having to go through that tribal rite, that can at least create a pause at a time that's right. And we're not going to have--

MR. CROSS. I think there have been some occasions recently when--

VICE CHAIRMAN CORRIGAN. The recent past.

MR. CROSS. --the market was very sensitive to such a thing and it could have had considerable influence.

MR. ANGELL. [Unintelligible] an impact.

MR. JOHNSON. Okay, well--

MR. MELZER. It seems to be in the realm of possibility, doesn't it?

MR. CROSS. Yes.

MR. ANGELL. Your insurance goes to those people who want to take comfort in being short in the dollar.

SPEAKER(?). You're underscoring too many risks in the market.

MR. PARRY. What I'd like to ask Sam about is this: If you have a situation where the French and the Germans and the Japanese did nothing and we eased policy and we intervened, I have the feeling that the New York traders would sell dollars.

CHAIRMAN VOLCKER. They might.

MR. CROSS. That could surely happen.

CHAIRMAN VOLCKER. I think you're right. In all these circumstances, that would probably happen. But the question still remains: Would they sell a little less eagerly and actively if we were giving this contrary signal?

MR. PARRY. Well, if they think that it's going to come back to a natural rate then you're giving them even more profit because you took the dollar up. They'll sell and then [unintelligible] down. Right?

CHAIRMAN VOLCKER. Maybe, maybe not.

MR. PARRY. Traders very often have bet against intervention because intervention hasn't been very successful.

MR. CROSS. There are too many possibilities and too many situations.

CHAIRMAN VOLCKER. [Unintelligible] judgment at the time as to whether you're going to be. And it's very hard to--

Mr. JOHNSON. I do agree there are rare opportunities when it could be useful.

VICE CHAIRMAN CORRIGAN. Well, I agree with Sam. If you think about the last six weeks or so--maybe the last two weeks in particular--there may well have been a point or two in that time frame of the last six or eight weeks where we might have been able to sneak in there with the Japanese or with the Germans, or both, and get some stuff done without having to go through--

MR. GUFFEY. I have a hard time envisioning, under the current circumstances, that we would do intervention without coordination with the Germans and the Japanese.

CHAIRMAN VOLCKER. Well, right now, the direction we're talking about we would get coordination with them.

MR. GUFFEY. At least you'd have the up and up.

CHAIRMAN VOLCKER. I'll give you one not very far removed type of hypothesis--a situation that did arise a couple of weeks ago. Suppose we were sitting right in the posture we're sitting with and, say, we don't want to move at the moment--we want to wait for a little more evidence of monetary growth or an improved economy. Yet we have a little tendency in that direction as time passes, but the dollar gets very weak in the meantime. So it begins forcing that decision sooner than we otherwise would want to do it. We might say: "Well, let's try a little intervention in here because we don't really want to take that step toward tightening but we're getting a little concerned, or more than a little concerned, about the dollar." It might work or it might not work. But I guess the question is: What do we lose by trying to buy a little time at the very least by doing the intervention?

MR. PARRY. But [unintelligible] with the fundamentals.

CHAIRMAN VOLCKER. Well, except unresolved fundamentals. We go against; we might be doing it in the future. We're not going to get into fundamentals.

MR. PARRY. Yes.

CHAIRMAN VOLCKER. And that is more or less where we are now. The dollar is weak at the moment. We're slightly biased in what we see for the future but we're not very eager to have to respond by general monetary policy to a pronounced weakness in the dollar. In that particular situation, apart from this negotiating Wayne suggested, is that the right time to be quite willing or--depending upon the situation--even eager to intervene?

MR. JOHNSON. Another--it may not [unintelligible]--prime opportunity later would be this: If it does so happen that the aggregates are growing strongly and the economy is picking up quite substantially and we literally do decide in July or whenever that in fact we need to tap the brakes a bit, it would be a great opportunity to use that decision to buy dollars and--even though we're going to do it anyway--if Germany and Japan still are dragging their feet on stimulating their economies and it's clear that we are alone, we could offer to support the dollar and see if that might lead to a better situation with the Germans and Japanese.

CHAIRMAN VOLCKER. Given all the permutations and combinations, I think I got about as much guidance as I could get in the absence of specifics.

MR. FORRESTAL. Does the question arise because there has been a shift in the Treasury's sentiment about intervention?

CHAIRMAN VOLCKER. I think the question arises because there hasn't been any shift.

MR. JOHNSON. They too--

MR. ANGELL. Well, of course, I have some concern here that intervention ultimately is a monetary policy decision. I'm very sympathetic with Bob Parry in regard to that. I don't like to lose anything. Whenever you start off and do something you prove you're going to lose, I don't think that helps you. Personally, I would tend to prefer not to intervene on a sterilized basis unless I were willing to make a monetary policy adjustment relative to the two other countries. It just seems to me that the Secretary of the Treasury has been the person carrying the ball here on this topic. And it's somewhat of a monetary policy topic, so I think maybe it's appropriate for the Federal Reserve to have the Chairman speaking on some of these issues from time-to-time. I'm somewhat encouraging him in that direction.

CHAIRMAN VOLCKER. I don't think that this conversation is inconsistent with that. I'm not sure how we would come out on a specific [proposal], but I think we've probably gone as far as we can go in the absence of something specific. If there's nothing else, we have a meeting in July. We may have a consultation before that if something happens. We can go eat lunch.

END OF MEETING